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BOOK REVIEWS

Practical Financial Statement Analysis—Third Edition

By Roy A. Foulke, McGraw-Hill Book Company, New York, 1953. Pages: 710 + XXI; $10.00.

The author, vice-president of Dun and Bradstreet, Inc., has for many years been a student and privileged observer of the financial condition of business organizations. This work, therefore, represents a history of commercial credit, an explanatory background of accounting terms and practices, and a discussion of the important financial ratios. Despite the emphasis on ratios, the author is careful to point out that the ratios are only symptoms and that the great unknown is always management. However, nothing is said about the effect of current conditions on the analyst's decisions.

Discussion of the various ratios is illustrated in each case by the presentation of three illustrative cases and a table showing the median percentages for the years 1947 to 1951, for representative lines of business activity and a five-year average of each median. In addition, the appendix has a 1951 table of fourteen important ratios for 72 lines of business activity, divided into upper quartile, median and lower quartile classifications.

To one understanding the limitations of ratios, the tables should be valuable and represent a contribution to our store of information, as they have been developed from a broad sample of reports.

In the discussion of the cases and also of accounting practices, the author takes very definite positions and brooks no opposition. As a result, the reader may heartily disagree with the conclusions drawn and the opinions expressed.

Mr. Foulke quite evidently dislikes Accounting Research Bulletin No. 30, published by the Committee on Accounting Procedure of the American Institute of Accountants. In fact, in discussing the inclusion of prepaid insurance and advance royalties (among others) as current assets, he says "not one of these items would be considered a current asset by a qualified analyst or an experienced accountant." He likewise states that "Accounts receivable due for the sale of plant, for the sale of used machinery or from officers . . . or other employees are not current assets; they are miscellaneous assets." Apparently no criteria as to collectibility or intent are to be considered or permitted.

It follows naturally, then, that Bulletin No. 14 should also be under attack. However, many capable and qualified accountants feel that showing that provision for discharging income tax liabilities has been made is an important point, the reflection of which pre-

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Book Reviews

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vents distortion of balance sheet relationships.

The author's uncompromising rigidity of approach and procedure is epitomized when he deducts the $2 book value of patents and trademarks from an approximately $4,000,000 net worth in order to arrive at the tangible net worth.

Admittedly, the author of a text on statement analysis is limited to an exposition of the devices used and a discussion of the other factors to be considered. The appraisal of the condition of a company, its prospects and the record of its management requires mature, experienced judgment which is tempered by the economic and political conditions at the time of analysis and the analyst's forecast of the future. Appraisal based on ratios alone is not sufficient.

FRANK A. DUNN

New York, N. Y.

Long-Form Report Practice

A Study by the Research Department of THE AMERICAN INSTITUTE OF ACCOUNTANTS, New York, N. Y., 1953. Pages: 162; $3.00.

Long-form audit reports are the tangible representation of the work which has been performed and, as such, merit the careful thought of the practitioner. Yet, because of their confidential nature, they are seldom available for comparison with the work of others.

In this study 52 reports have been analyzed so that we may check our own presentations and practices with those of the group furnishing the materials for the study. The principal classifications of the work cover characteristics of, excerpts from, and specimen long-form reports.

The characteristics range from the physical size and style of reports to the technical presentation of statements, comparison and regrouping of figures, and outlines of procedures. In Part II, we find selected excerpts covering a range of subjects from aging of receivables and certificates from clients' officers to analysis of profit variations. Part III presents reproductions of five complete reports.

This work naturally cannot present what might be classified as approved or recommended practices. However, it does provide a yardstick against which we can rate our own reports and it may be a source of ideas for our own presentations. As such, it is a useful addition to our body of accounting literature.

FRANK A. DUNN

New York, N. Y.

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Book Reviews

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Tax Manual for Divorce and Separation

By Charles B. Bayly, Jr. NEWKIRK ASSOCIATES INC., Albany, N. Y., 1953. Pages: XX + 291; $10.00.

Too often financial arrangements incident to divorce or legal separation are made without thought as to the income tax, estate tax and gift tax consequences. The tax objectives of the spouses should be considered before—not after—the divorce or separation. This requires proper planning which, in turn, necessitates knowledge of the tax aspects involved. Here is a book intended to be a source of information as to those tax aspects.

The method of compilation is best described in the author's own words:

> "Therefore in this book the method of presentation of all of the material under those provisions of the Internal Revenue Code concerned with divorce or legal separation is a consecutive word by word, phrase by phrase, and clause by clause analysis of each relevant statute. The material under each particular word, phrase, or clause is then presented chronologically showing the development over the years of its interpretation."

The book contains a detailed "analytical outline", by paragraphs and subparagraphs—a sort of super-table of contents—at the beginning and an extensive index and table of cases at the end, to help the reader locate any particular phase of the subject quickly. There is also a table of suggestions for clauses in separation agreements. This reviewer would like to see such section amplified and the clauses presented in language suitable for use in agreements rather than paraphrased as they now are.

This is a very comprehensive study of a limited area of taxation. Since the subject is in a state of flux with new decisions resulting in new interpretations, it is hoped that it will be kept up to date from time to time by the issuance of either supplements or later editions.

LEONARD PRICE

New York, N. Y.

1954 Pay Almanac

By William J. Casey, J. K. Lasser, and Walter Lord. BUSINESS REPORTS, INC., Roslyn, L. I., N. Y., 1954. Pages: 166; $12.50.

This research study analyzes the major problems in 1954 affecting both rank and file and management pay, and presents data in

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BOOK REVIEWS

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comparative form to help management set intelligent pay policies for their employees. In doing so, the attention of management is invited to government policy trends and the attitude of the Treasury Department with respect to the different types of plans which are referred to and presented.

The authors outline a fair number of plans already adopted by representative companies throughout the country and stress the safeguards which should be kept in mind by an employer in his consideration of any one of them for possible adoption in his own establishment.

Trends of labor demands already being discussed, as well as those which are contemplated, are taken up, and the likelihood of their success is indicated. Consideration is given to such topics as further welfare benefits, guaranteed pay, etc., how management can prepare for them, and the type of safeguards that can be set up.

The latest developments and thoughts in bonus and profit-sharing plans are presented, as are employee thrift plans, employee stock plans, pension and other plans adopted by business for the purpose of attracting and holding key personnel. The authors give consideration to the need for protecting stockholders from company abuse and for protecting the company from Treasury Department attack.

Plans adopted by management for family protection, for health and welfare, and for vacations are also taken up, as are their inducements through providing better living conditions, recreation, and training.

Finally, the authors present comparative pay data for different types of workers in different areas throughout the country.

The *1954 Pay Almanac* should prove to be a good reference source for helping management solve pay and employment problems which will arise during 1954.

STANLEY B. TUNICK

Baruch School of Business and Public Administration
The City College of New York

Guide to Pension and Profit Sharing Plans

By Robert S. Holzman; Saul B. Ackerman collaborated as editor. FARNSWORTH PUBLISHING CO., INC., Mount Vernon, N. Y., 1954. Pages: 64, paper covered; $1.50.

This booklet, written in language as easily understandable to the layman as to the lawyer, consists entirely of questions and answers. It defines exactly what it means by pension and profit sharing plans, and then

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Book Reviews

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goes on to discuss their intricacies under these headings:

Types of Plan
Contributory Plans
Approval of the Plan
Exclusions and Discrimination
Vesting and Forfeitures
Getting the Tax Deduction
Past Service
Benefits
Integration with the Federal Social Security Act
Taxability of Beneficiary
Unions
Affiliates
Terminations
Retirement
Pension versus Other Benefit Plans
Formalities
The Trustee
Costs

It will be a handy reference and useful guide on its subject for life underwriters and the attorneys, accountants and trust officers who make up the complete estate planning team. It will be helpful to anyone who is getting his first introduciton to employee welfare plans involving pensions and profit sharing. It can also serve well as a teaching and training instrument. It will be a useful addition to the library of the employer in every field of business, regardless of the size of his enterprise.

Guidebook to Federal Estate and Gift Taxes—Second Edition

By the Editorial Staff, COMMERCE CLEARING HOUSE, INC., New York, 1953. Pages: 135, 6" x 9", heavy paper covers; $2.00.

Of particular interest to everyone responsible for the sound solution of federal estate and gift tax problems, this new Commerce Clearing House book affords helpful explanations, and direct references to law and regulations. In addition, it is designed to be of immediate, practical assistance in the effective preparation of federal estate and gift tax return forms. Forms reproduced in full, and filled in with typical facts and figures, reflecting recent important statutory changes and amendments, include the following: Form 704 (Preliminary Notice); Form 706 (Estate Tax Return); Form 709 (Gift Tax Return); and Form 710 (Donee's or Trustee's Information Return). Detailed table of contents; estate and gift tax index.

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VOL. XXIV *March • 1954* NO. 3

Loss of Classification of Real Estate Corporations Under Section 182 of Article 9 of the Tax Law

By ALLEN J. GOODRICH, C.P.A.

MEETING with you here tonight is rather like old home week for me. But I confess I would feel more at ease if I were among you in the question panel, rather than up here on the answer spot.

I believe I am the first accountant to head the State Tax Commission in New York. So perhaps I may merit your patience while I become somewhat more acclimated to this rarified atmosphere which heretofore has been breathed exclusively by our brethren of the bar.

Someone once remarked—and I suppose it was an accountant—that it takes lawyers to write these tax laws—but accountants to figure out what they mean. Sometimes I wonder whether the answers are beyond the reach of both.

However that may be, I have discovered that it is easier, and a good deal more fun, to devise tax questions than it is to find answers which satisfy accountants and their clients, and at the same time keep the revenue rolling in. And please remember that it's now my job to find more than one billion dollars every year so that local and State government services may be maintained.

ALLEN J. GOODRICH, C.P.A., has been a State Tax Commissioner of the State of New York since 1948, and is now President of the Commission.

Mr. Goodrich began the practice of public accounting in 1922, and served as chief accountant (from 1935 through 1942) under Thomas E. Dewey, when the latter was special prosecutor and, later, District Attorney of New York County. He became Deputy Comptroller in charge of State Audits in 1943, and was placed in charge of the New York State Employees' Retirement System in 1948. He also served, by appointment of the Governor, as a member of several State Commissions.

This paper was recently presented by Mr. Goodrich at a technical meeting of the Society held under the auspices of the Committee on State Taxation, December 1, 1953, at the Engineering Societies Building in New York City.

In administering the laws designed to produce our needed revenues, the Tax Commission owes much to the accounting profession. Were it not for your specialized services and skills, it simply would not be possible for government to administer a modern revenue system. Nor would it be possible for many taxpayers to comply with the laws which make up the system.

But beyond your important services to client taxpayers, accountants have made substantial contributions in ideas and in legislative proposals, looking toward more equitable distribution of the tax burden. Our relationship, therefore, is one which can—and does—promote broad public interests.

Basic Policy of the Tax Commission

Recently, at a meeting of some tax men—possibly including some of you present tonight — I attempted to restate the principles which will guide the Tax Commission in doing its job. It might be useful to repeat them here, by way of preface to our later discussions:

1—We shall do our best to administer fully and effectively the duties assigned to us by the Legislature.

2—We shall, however, strive to make tax compliance as easy, convenient and inexpensive for the taxpayer as is possible, consistent with the requirements and limitations imposed by statute, by simplifying procedures, forms and methods.

3—In discretionary matters, we shall try always to be fair and just, giving taxpayers ample opportunity to be heard and to present every fact which may have a bearing on our decisions.

4—We shall endeavor at all times to protect the interests of the State, but shall be no less zealous in safe-guarding the rights of the taxpayer.

5—We shall, insofar as it is possible, gear our operations and procedures to the practices and methods of the taxpayers, so that any changes in State tax laws, or regulations, will not result in unnecessary red tape, either in our offices or in the taxpayer's office.

6—We shall be glad to discuss, with taxpayers and their representatives, any proposals for new legislation which may originate either within or without the Department.

Problems in the Taxation of Real Estate Corporations

With that as a working plan, we hope to work toward elimination of specific trouble spots. One of the projects we are going to undertake is clarification of the Commission's policies in matters where some confusion still appears to exist.

There may be a number of such matters. For a starter, it seems to me that there is considerable misunderstanding in connection with real estate corporations taxable under Section 182 of Article 9—especially as regards provisions for reclassification of such corporations under certain circumstances which make them taxable instead under Article 9-A. There are about 44,000 real estate corporations which file returns under Section 182. During the past year, there were 3,200 reclassifications—either from Section 182 to 9-A or vice-versa.

The law defines real estate corporations, for purposes of the tax under Section 182, as those wholly engaged in the purchase and sale of and holding title to, real estate for themselves; those wholly engaged in the business of subleasing real property held under a leasehold for a term of 20 years or more, by the terms of which taxes on the real property are paid by the lessee corporation as part of the consideration for the leasehold, and those wholly engaged in holding title to bonds, notes or other obligations of the purchaser received upon sale of real estate or leasehold and secured thereby.

Real estate corporations, under Section 182, pay a franchise tax of one-quarter mill on each dollar of gross

assets at full value employed or situated in the State in the preceding year. There is an additional tax of 2% on allocated dividends paid. The tax is on a calendar year basis, returns being due by March 1 following.

Upon change of classification (as upon liquidation, or prior to dissolution, merger or consolidation) the corporation becomes subject to a tax of 2% on the sum of dividends distributed and not previously used as the basis of tax, plus 2% on the corporation's actual net worth in excess of its paid-in capital apportioned by the segregation of assets shown on the taxpayer's annual report for the preceding year.

Now, when does a real estate corporation, subject to this tax, cease to be a real estate corporation and become subject, instead, to the corporate franchise tax under Article 9-A? That is a common question and one which, if disregarded by the accountant, can lead to tax difficulties for the corporation. In some cases, it can be expensive, in terms of tax results.

The law seems to be clear enough. The statute provides that a corporation taxable under Section 182 will not lose its classification if

(1) not more than 10% of its average gross assets, at full value, consists of stocks, bonds or other securities or loans to wholly owned subsidiaries taxable under Section 182;

(2) it holds or acquires the entire capital stock of one or more corporations taxable under Section 182 of Article 9; and

(3) it holds United States securities purchased on or after January 1, 1941, and owned on December 31, 1946.

This was further clarified in a decision of the Tax Commission at a 1942 conference that in all cases where a corporation has been properly classified as a real estate corporation under Section 182, no change in classification to another section will be made until some affirmative act takes place which would require such reclassification.

Therefore, if a corporation disposes of its real property and has remaining only cash or securities not in excess of the 10% provision, or is without assets and has not engaged in any other business, the corporation will be permitted to retain its classification as a real estate company and be subject to the provisions of Section 182.

Now, what might be considered affirmative actions under which a real estate corporation loses that classification and becomes taxable under 9-A? There are two which come to our attention repeatedly.

The first is the case of the corporation which does not meet the 10% provision. That is, we find the corporation has more than 10% of its average gross assets invested in stocks, bonds or securities.

In determining the 10% factor, various items are not considered as investments under this law. Excluded are purchase money mortgages; stock of a corporation taxable under Section 182, 100% of which is owned by the taxpayer; and United States Government bonds purchased on or after January 1, 1941, and owned on December 31, 1946.

Other items which are not to be included in investments in determining the 10% are Treasury stock, shares of a savings and loan association and mortgages not taken in payment of real estate sold by the taxpayer but taken over through merger or consolidation from another corporation which did sell the real estate.

Bearing in mind these exclusions, Article 160 of 9-A regulations provides that if, at the end of the year, a real estate corporation has more than 10% of its average gross assets at full value in stocks, bonds or other securities, its classification must be changed as of the first day of the succeeding year, when it becomes subject to tax under Article 9-A. There is no pro-

vision in the law for any period of grace to reduce the investments and retain the real estate corporation classification in these circumstances.

The second common action leading to reclassification of a real estate corporation is the making of loans. The law makes no provision for a real estate corporation, taxable under Section 182, to lend money, except to wholly owned subsidiaries. If it does make loans, reclassification to Article 9-A as of the date of the loan is necessary.

A real estate corporation also loses its 182 classification and goes under 9-A if it rents tangible personal property to others, if it owns an apartment house which rents a furnished apartment, or if any material part of its real property is used or occupied in the conduct of the business of a corporation subject to tax under Article 9-A, and either (1) substantially all of its capital stock is owned or controlled, directly or indirectly, by such corporation, or (2) substantially all of the capital stock of both corporations is owned or controlled, directly or indirectly, by the same interests.

I haven't attempted to cover the problems of reclassification in detail. But if you want to develop this subject further, I think we can do so profitably in our subsequent question-and-answer discussion.

Finally, I do want you to know how much we appreciate your assistance, as individuals and as an organization. We need your help and shall continue to expect it. By the same token, we offer you our fullest cooperation to the end that we may together serve better the interests of both State and taxpayer.

Tax Practice Before State Bureaus

By MORTIMER M. KASSELL

THE title of these remarks appears far more formal than the subject really requires. The fact is, at least so far as the New York State Tax Commission is concerned, that the practice before it is far less legalistic and formidable than before most tax authorities. The Commission has endeavored, and to a large extent succeeded in keeping the procedure as simple as possible, at least as far as possible within the framework of the statutory requirements. The aim is to constantly and continually endeavor to simplify procedures, not for the benefit of the administrators but primarily for the benefit of taxpayers and their representatives.

Change in Accounting Period—Personal Income Tax

There are many aspects of practice in which you will be interested. Although I intend to chiefly discuss practice on applications for revision or refund, I would first like to tell you of an important step recently taken by the Tax Commission to cut the red tape surrounding changes in accounting periods for personal income tax purposes. Under former practice, every taxpayer desiring to change his accounting period was required to apply and obtain permission from the Commission to make such change, whether or not a similar change in accounting period was permitted for Federal income tax purposes. Under an amendment to Article 528 of the Personal Income Tax Regulations promulgated November 20, 1953, the Tax Commission will automatically allow the taxpayer to change his accounting period for New York State personal income tax purposes where such change in accounting period is permitted for Federal tax purposes. All that the taxpayer is required to do is to attach to the first return filed by reason of such change in accounting period either (1) a copy of the consent of the Commissioner of Internal Revenue to change the basis of his return for Federal tax purposes, or (2) if, pursuant to section 39.46-1 of Federal Income Tax Regulations 118, the consent of the Commissioner of Internal Revenue is not required to effect a change in accounting period for Federal income tax purposes, a statement to such effect.

No State Enrollment Requirement

It should be observed at the outset that it is not necessary to enroll in order to present a matter before the State Tax Commission. Lawyers, certified public accountants, accountants and taxpayers themselves may and do appear before the Commission itself or before any of the numerous bureaus of the Department. However, it is

MORTIMER M. KASSELL, ESQ., is Deputy Commissioner of Taxation and Finance and Counsel to the New York State Tax Commission. He is a graduate of The College of the City of New York, 1926, and Columbia Law School, 1929. He is a member of the Executive Committee of the National Tax Association, a member of the Committee on Drafting of the American Bar Association, a member of the Taxation Committee of the New York State Bar Association, and an advisory member of the New York State Joint Legislative Committee on Interstate Cooperation.

This paper was recently presented by Mr. Kassell at a technical meeting of the Society held under the auspices of the Committee on State Taxation on December 1, 1953, at the Engineering Societies Building in New York City.

advisable, at least at a hearing, to be armed with a power of attorney executed by your client.

I shall deal principally with the practice on applications for revision of the income taxes, personal and unincorporated business, as well as the franchise taxes, and shall, generally, treat them altogether because of the many similar aspects to the practice and procedure.

Normal Audit and Assessment Procedure

Roughly, there are filed annually with the Commission approximately 4,500,000 income tax returns and some 300,000 franchise tax reports. The majority of returns are accepted and filed without further ado. Some returns on their face show that a refund is due, for example, where a taxpayer forgets the 10% tax reduction. In that event, a refund is made without any action on behalf of the taxpayer. Inevitably, some returns do contain questionable items of income, deductions or allocation. In some of these cases the returns or reports go directly to the Field Audit Sections. In most cases the Tax Commission endeavors to ascertain the facts by correspondence.

At this point let me emphasize the importance of answering the initial letter of inquiry fully and promptly. It is highly advisable to furnish as complete data as possible. If it is necessary to obtain more information from your client then reply to the letter of inquiry and ask for additional time. There is a thirty-day limit for answers to personal income taxes but no limit for franchise tax purposes. In all events, answer promptly and identify the taxpayer and the file number accurately. If you do not, you run the risk of an assessment, either for failing to supply information or based on the questionable items.

Although many, in fact most, cases are disposed of through correspondence, other cases result in additional assessments. For example, from April 1, 1952 to March 31, 1953, almost 140,000 income tax assessments were issued. By statute, assessment of both income and franchise taxes are required to be paid within thirty days, otherwise further penalties accrue. Except in the case of fraud, personal income tax assessments must be issued within three years from the due date of the return, or if more than 25% is omitted from gross income, then within five years. In the case of fraud or if no return is filed, an assessment may be issued at any time, for either income or franchise tax purposes. In the case of the franchise tax the Commission has five years from the filing of a report to issue an assessment (called an audit and statement of account or a reaudit and restatement of account). There has been recommended to the State Tax Commission a proposal to reduce the time to issue franchise tax assessments so that it will be the same as for income taxes. That proposal is under consideration and if approved will be recommended to the Legislature. The periods of time within which the Commission may issue assessments may be extended by taxpayers' consents, just as in the Federal practice.

Application for Revision or Refund of Income Taxes

As heretofore noted, assessments, both income and franchise, must be paid within thirty days, otherwise further penalties accumulate. If you dispute the assessment, you must comply with the statutory procedure for review, otherwise you will lose your right of review. I cannot too strongly emphasize this aspect of practice before the Commission. Since the rules differ for income and franchise taxes, I will briefly outline them separately.

For income tax purposes the procedure is as follows:

1. An Application for Revision or Refund must be filed within one year from the date of mailing the notice of assessment, or within two years after

the due date of the return, whichever is later.

2. The application must be filed in duplicate.

3. Form IT-113 prescribed by the Tax Commission must be used.

4. The application must

(a) set forth each ground separately,

(b) contain a statement of facts sufficient to apprize the Commission of the basis of the claim,

(c) be made separately for each taxable period,

(d) be filed and verified by the taxpayer or his agent and if by an agent, there must be a power of attorney annexed.

Unless each detail which I have mentioned is complied with, the Tax Commission considers that it is without power to revise or adjust any income tax assessment. On this point I must confess that the statute prescribes a highly technical and legalistic approach. I can only advise that you recognize the importance of the problem and that you carefully comply with the necessary procedural steps.

Application for Revision or Refund of Franchise Tax

As to revision of a franchise tax assessment, the rules are not quite so technical. However, an application for revision must be filed within two years from the date of such assessment if an original audit and statement of tax, or one year from the date of a reaudit or restatement. Although a letter application may be sufficient if timely filed, form 7 C.T. must in any event be filed to substantiate the application. This form also must set forth each ground of application and must be filed for each year. It must also be verified by an officer of the taxpayer corporation.

Again, it should be emphasized that the filing of an application for revision for either income or franchise taxes does not extend the time to pay the tax assessed.

Conference or Hearing Procedure

For both income and franchise tax purposes informal conferences or hearings may be held to determine the facts. Ordinarily, income tax conferences are wholly informal but at franchise tax hearings witnesses are examined and their testimony taken. The purpose of the informal conferences held with respect to income taxes and the informal hearings held with respect to franchise taxes is to develop the facts. The conferee or the hearing officer endeavors to develop a complete statement of all the facts whether they support or refute the assessment. The purpose of the conference or hearing is to reach a correct conclusion as to the law applicable to the facts. The purpose is not merely to sustain the assessment. In fact, as a result of hearings or conferences over 90% of all assessments, income or franchise, are disposed of.

An informal hearing on franchise taxes is held by a member of the Board of Conferees. He reports back to that Board which consists of three members, which decides the question.

If an application for revision of an income tax assessment is granted, the assessment is cancelled or a refund made, as the facts require. If the application is denied, the taxpayer is advised of the denial and of his right to demand a hearing. The demand for a hearing must be filed with the Commission and must be on form IT-114. It must be filed within ninety days after the application for revision was denied. Only one copy of the demand is necessary.

After receipt of a demand for hearing, a preliminary or informal hearing may be held, or a formal hearing may be held by a duly designated official of the Commission. The hearing is in the nature of a trial but, like most administrative hearings, is not

governed by formal rules of evidence. Witnesses are examined under oath, and their testimony transcribed. It is important to know that assessments of the Tax Commission are *prima facie* correct and that the taxpayer must prove the nature and extent of any error in order to overthrow an assessment. The hearing officer, after consideration of the minutes and argument on behalf of the taxpayer, forwards to the State Tax Commission a proposed determination which briefly sets forth findings of facts and conclusions of law. The Commission reviews the file and if in accord with the conclusion of the hearing officer, executes the determination which is then mailed to the taxpayer.

The procedure for franchise tax purposes is somewhat different. If the Board of Conferees disagrees with the taxpayer's position, the taxpayer is so advised and is requested to withdraw its application for revision. If the taxpayer does not withdraw its application, the case is set down for formal hearing without the necessity of the taxpayer filing any other document, such as form IT-114 used for income tax purposes.

Court Review of Commission's Determination

If a taxpayer receives an adverse determination of income or franchise taxes he may review the action of the Commission in the courts. The review is in the nature of certiorari under Article 78 of the Civil Practice Act and is by application to the Supreme Court, Albany County. The application must be made within ninety days after the determination of the State Tax Commission is mailed, and the Commission must be given eight days' notice of the application. The taxpayer must also file a bond to secure the costs of the appeal, or if the tax has not been paid, must file an undertaking to also cover the tax, interest and penalties.

Current Statistics

The statistics with respect to applications for revision before the Commission are interesting. Thus, for income tax purposes, from April 1, 1952 to March 31, 1953, as heretofore noted approximately 140,000 assessments were issued. During that period, less than 8,000 applications for revision were filed. In other words, approximately 94% of the taxpayers agreed with the Commission's action. During that period only 700 demands for formal hearings were filed and about 100 hearings were held.

As to court cases, there were four in the Appellate Division and three in the Court of Appeals. Of the seven cases, four were decided in favor of the State, two are pending and one discontinued upon payment of the tax by the taxpayer.

The statistics with respect to franchise taxes show that even fewer assessments were disputed by taxpayers or reviewed in the courts.

These figures are the only concrete evidence available as to the general functioning and administrative philosophy of the New York State Tax Commission. Cynics may say this means that the Commission is too easy, but the fact remains that the Commission has by a fair and just administration of the New York tax laws achieved a high degree of taxpayer cooperation and public good will. That kind of a result stems from a long administrative experience and a hard-working and well trained staff.

Estate Tax Procedure

There are, of course, many other aspects of practice and procedure before the State Tax Commission. Unfortunately time does not permit of an extended examination of them. One other aspect should also be mentioned because it is not generally understood and that is, the handling of estate tax matters.

The estate tax, like its predecessor, the transfer tax, is administered primarily by the various surrogates of the State. It is not directly administered by the State Tax Commission, as are practically all other state taxes. The surrogate is the official who assesses the estate tax. The practice is for the surrogate to appoint an appraiser. The appraiser acts as a quasi-judicial officer, an assistant to the surrogate. His function is to value the assets of an estate and to report to the surrogate. He has the power to examine witnesses and take depositions. In practice he has a large accounting staff which consults with taxpayers and their representatives. Although many of the problems are essentially of a legal nature and require advice of lawyers, in many aspects accountants provide a great deal of aid to executors and to the accounting staff of the appraiser. For example, the problem of valuing closely held stock is one in which the members of your profession can and do perform valuable services for an analysis of earnings records, profit and loss statements and balance sheets is a job that can only be done well by an accountant. The procedure before the estate tax appraiser is generally informal. The appraiser makes a report to the surrogate who enters a *pro forma* order fixing the estate tax. In so doing, the surrogate acts as the tax assessing officer—a purely ministerial function. If either the estate or the Tax Commission is dissatisfied it may appeal to the surrogate who now acts as a judicial officer. On the appeal accountants are frequently witnesses. They interpret for the court and the lawyers the meaning of the various books of account and testify as to values.

Compromise of Taxes

One other aspect of practice should also be mentioned. That involves the compromise of taxes in certain limited cases. Where a tax debtor has been discharged in bankruptcy, or is insolvent, his tax liability may be compromised by the State Tax Commission. This applies to all taxes administered by the Tax Commission. For personal income tax purposes an application for compromise (form IT-107) must be filed indicating the taxes to be compromised, the amount offered in compromise by the taxpayer, facts showing the bankruptcy or insolvency of the taxpayer and other pertinent information. While no specific form is provided, the taxpayer is required to furnish similar information in applying for a compromise of franchise taxes.

In this connection, attention should be directed to the existing situation where a taxpayer is bankrupt or insolvent and owes Federal and state taxes. If there is a formal bankruptcy, then the Bankruptcy Act clearly provides that Federal, state and local taxes have a priority and are to share *pro rata*. However, if there is no bankruptcy adjudication, but the tax debtor is insolvent, the Federal Government insists on its priority as granted by section 3466 of the Revised Statutes. The position of the Federal Government is of course inequitable for the tax claims of the United States, the states and the local governments should be on a parity in all cases. Of course, if the state tax is paid first, the priority of the United States is meaningless.

For almost twenty years it has been my privilege to address various meetings of your Society. I am not sure that I have greatly contributed to your knowledge, but I am sure that I have enjoyed meeting with you and trying to answer your provocative and sometimes unanswerable questions.

Note on the Reproduction of New York State Tax Returns

By THE COMMITTEE ON STATE TAXATION

DESPITE several notices by the New York State Society of Certified Public Accountants to its members and publicity notices in its journal, there still remains a certain amount of confusion in the minds of practitioners as to the conditions upon which the State Tax Commission will accept reproduced tax forms. The Society has been informed by the Income Tax Bureau that they are receiving copies of returns filed on paper which does not meet their specifications as to *color, weight, manner of folding* or *fastening, etc.* They have indicated that they will take stern measures in regard to these forms so that practitioners may not only find themselves in an embarrassing position client-wise but may be obliged to refile all of these returns. Furthermore, if this continues, the State Tax Commission may completely revoke the approval given with regard to the reproduction of tax returns.

Because of the foregoing, the following summary is being submitted so that practitioners may know definitely the position of the State Tax Commission on this matter:

Scope of Approval

Thus far, representatives of the Society have received direct approval only for the diazo direct copy-making process (Bruning, Ozalid, etc.). We have been informed that the multilith process has been approved upon direct application by individual practitioners. Practitioners using any other process are urged to *demand proof* from the manufacturers that the specific process in question has been approved. Most reputable manufacturers have secured approval in writing and are in a position to comply with such request.

Conditions of Approval

The specific conditions upon which the aforementioned approval of the diazo process was given follows:

Color

With the exception of the real estate franchise return (Form 42 C.T.), the color of the paper upon which the returns are reproduced must conform to the color of the official form. Thus, Forms 201 and 205 must appear on yellow paper; Forms 3 C.T., 3 C.T.-1 and I.T. 115 must appear on white paper. With regard to Form 42 C.T., the Society was unable to secure yellow paper the exact color of the official form and, therefore, submitted the reproduction for approval on the nearest similar shade of yellow which was the Bruning 141Y, 17-lb. paper. This request for approval was approved despite the difference in shade. Practitioners are urged to see that the paper used by them for the reproduction of the Form 42 C.T. is either the exact shade as the aforementioned Bruning 141Y paper or that their manufacturer has secured permission for any alternative shade.

The color of the reproduced image (letters, numbers, lines, etc.) must be black.

The submission of returns on the wrong color paper is an important offense in the eyes of the Commission since their sorting and filing procedures are largely predicated on the color of the return.

Weight

The State Tax Commission has approved the reproduction of returns on 17-lb. paper. Practitioners are urged to check with their suppliers that the weight of their paper is not in excess of the approved figure. The State's approval recognized that the reproduction may be made on one side of the paper only, thus requiring double-fold returns.

Single-Sheet Reproductions

Some machines in use can reproduce single-sheets only. It is, therefore, necessary for practitioners to join the

(Continued on page 168)

Tax Dangers in the "Close" Corporation

By RICHARD S. HELSTEIN, C.P.A.

WHILE statistics are not available, it is a pretty safe guess that the majority of corporation tax returns filed in the United States in the last few years are those of "close" corporations. A "close" corporation is a corporation which is privately owned, generally, directly or constructively,[1] by five or less individuals. While it has the perquisites and follows the procedures required of the corporate form of enterprise, in effect it is operated by the owners with the same intimacy as would be a partnership or a sole proprietorship. The officers and directors are usually the stockholders, and the decisions as to financial and other policies are considered rather from the standpoint of the individual owner than from that of the corporate entity.

Because the corporate form is used as a disguise for the conduct of a business which in many cases is operated, in fact, as a partnership, Congress and the Treasury Department have enacted many complex and restrictive provisions in the Internal Revenue Code in an attempt to obviate the use of the "close" corporation *solely* for tax avoidance purposes. To this end they have been aided by the Courts which have looked behind form to substance for business purpose.[2] As a result, there are many pitfalls, even in the simplest transactions, which may cause serious tax troubles for the unwary.

"Close" corporations, themselves, taxwise, may not be the most economical form of operation. The earnings of the corporation are taxed twice; to the corporation in the year earned, and to the stockholders when distributed. On the other hand, if the corporation operates at a loss, the officer and owner will still pay a tax upon his salary — which may be a tax upon capital if the net loss is greater than the salary paid. Nor can such corporate losses be carried back or forward against the individual's income.

Another problem is the necessity of having sufficient liquidity of assets to meet the tax payments under the present schedules. For taxable years ending on or after December 31, 1954, fifty percent of the tax must be paid when the return is submitted and the balance in the following quarter.[3] These payments will fall due right after the payment of dividends declared at the year's end, during the period of new inventory commitments, and when there are many other drains on cash resulting from year end tax planning.

The tax dangers for "close" corporations fall, naturally, into three groups: administrative, statutory and judicial. The dangers are as numerous and varied as the transactions available; and sometimes a single transaction involves multiple tax hazards. The following discussion is limited to a few

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This paper was presented by him at the Federal Tax Conference of the Society held on December 10, 1953, under the auspices of the Committee on Federal Taxation.

[1] Section 24 (b)(2), I.R.C.

[2] *Gregory* v. *Helvering*, 293 U.S. 465.

[3] In his message to Congress January 21, 1954, the President recommended that payments be made in September and December on an estimated tax for the year.

of the pitfalls which lie in the path of the single "close" corporation, and will, perforce, omit consideration of tax problems of affiliated groups, directly or indirectly controlled by the same stockholders.

Examination of Returns

The administrative danger arises through the routine examination of the corporate return. It exists because of the very fact that the corporation is a "close" one; because the corporation is owned and controlled by a few stockholders, who determine its policies, operational and financial, gearing those policies toward the reduction and minimization of taxes.

A Revenue Agent, examining the return of a "close" corporation will scrutinize more closely the deductions for officers' salaries, travel and entertainment, contributions, interest on stockholder loans, inventories, exchanges, and the methods of handling bad debts and sales returns.

In the past, when a deduction for officers' salaries paid to a stockholder had been partially disallowed on the grounds that it was excessive, it was nevertheless taxed to the recipient as a dividend. This left open the loophole that there may not have been sufficient earnings or profits, either current or accumulated, to allow such a dividend.[4] Now the Service taxes the income to the individual merely as Section 22(a) income—a difficult position to combat.

Furthermore, the Service has adopted a hostile attitude on both deferred compensation and on contingent compensation. However, it did receive a rather important defeat in a recent case in the Tax Court.[5] In that case, a corporation and its officer-stockholders had entered into a salary agreement based upon a percentage of profits. The agreement was made early in the corporation's existence when profits were low, and was accepted by the Commissioner. When the big years came, the Service attacked the salaries as unreasonable and excessive. The Court held that if the Commissioner approved the agreement in the lean years, the arrangement was no less good in the profitable ones.

Entertainment and travel expenses have always been a choice morsel for the examining officer, but a recent development in connection with the expenses deducted by an individual has opened up new hazards. In the *Sutter* case[6] the Tax Court found that of certain of the taxpayer's entertainment expenses, only the portion which was in excess of what he usually spent for meals, etc., were deductible, and that the balance was personal in nature. These expenses had been reimbursed to Sutter by his employer, and deducted on the employer's return. Thus it can follow that the amount reimbursed to Sutter which was disallowed by the Court as being personal in nature, would be disallowed to the employer as not being an *ordinary and necessary business expense* of the corporation.

Sometime during the course of the examination, the Revenue Agent will investigate the applicability of the penalty tax on the improper accumulation of surplus.[7] Because of much publicity, section 102 surtax has become a major consideration in the determination of dividend and other financial policies.

It is submitted that to a great extent the tumult and the shouting in connection with this section is unwarranted. When section 102 was first enacted in the Revenue Act of 1934, the surtax rates of 25% and 35% were comparatively high compared to the then corporate income tax rates of 13¾%, and compared with the individual surtax rates then imposed.

[4] Section 115 (a), I.R.C.
[5] *Home Packing Co.*, TC Memo Op. 1953.
[6] *Richard Sutter*, 21 TC, No. 20.
[7] Section 102, I.R.C.

However, today the penalty rates on Undistributed Section 102 Net Income[8] are 27½% on the first $100,000 and 38½% on the amount in excess of $100,000. *These rates may be much lower than those to which the stockholders are subject.* It must be borne in mind that the income subject to section 102 is taxable *only in the year earned,* and once the penalty tax has been paid, the remainder is not retaxable under section 102, and at some future date may be distributed subject only to capital gains rates. Thus, in 1954, for a stockholder in the 66% bracket, it is to his advantage taxwise to leave the earnings in the corporation, since the highest tax to which the section 102 net income can be subject is 63½%.

Furthermore, section 102 has been very difficult for the government to apply, since it has been incumbent upon the government to show that the retention of earnings was for the purpose of avoiding the surtax on the individual stockholders, and it has not been too hard for taxpayers to present a good business reason for the need to conserve funds. There have been far more victories in the Tax Court for the taxpayer than for the government.[9]

Personal Holding Company Tax

The Personal Holding Company tax[10] is a real penalty tax. The rates imposed are in addition to the normal and surtax (although Personal Holding Companies are not subject to the section 102 surtax). They are 75% on the first $300,000 of undistributed Subchapter A net income, and 85% on the balance.

This tax is a particularly dangerous pitfall because a corporation which has never been a personal holding company, which was organized designedly to be anything but a personal holding company, may inadvertently qualify as a personal holding company. And if it should be unaware that it so qualifies, it will be subject not only to the surtax, but to delinquency penalties for not filing a Personal Holding Company tax return. Furthermore, if no return is filed, the statute of limitations does not run, and the tax can be assessed at any time.

This situation, unfortunately, has occurred much too frequently, and the only argument that the taxpayer can advance is that it relied on "expert opinion" that it was not subject to the tax.

Therefore it is doubly important that accountants be aware of the trap in section 501 when preparing returns. That section provides that a personal holding company is one, 80% of whose *gross income* is personal holding company income, which includes income from rents, royalties, interest, dividends, gains from security transactions, etc.[11]

Why is this a hidden danger?

To illustrate, let us take the example of a manufacturing corporation. For many years this company has operated profitably, and part of its assets now consist in investments in securities, patents leased under royalty agreements, and rent from the sub-lease of part of its premises. In the current year, due to a radical change in raw material prices and other adverse events, its cost of goods sold exceeds sales. In such a situation, all of its *gross income* would be personal holding company income despite the fact that the company was operating as a manufacturing company as it had always done. In the current year, this

[8] Section 102 (d), I.R.C.

[9] It is proposed to revise this section in the 1954 Act so that the burden shall be upon the government to show that the earnings were retained for the purpose of avoiding surtax to the stockholders.

[10] Sections 500 through 511, I.R.C.

[11] Section 502, I.R.C.

manufacturing company is a personal holding company *because the qualifying 80% is applied to gross income—not gross receipts.*

And to pile disaster upon catastrophe, once a corporation qualifies as a personal holding company, it remains a personal holding company until the expiration of *three consecutive taxable years* in each of which less than 70% of the gross income is personal holding company income.[12]

Section 117 (j)

Section 117 (j) is a "heads we win, tails the government loses" section. It was inserted in the Code to give the taxpayer a break. In many cases, however, full advantage is not realized from the use of this section.

Under section 117 (j), gains and losses realized in the same taxable year on the disposition of certain property used in the trade or business[13] are netted against each other. If there is a net gain, it is a capital gain, and only fifty percent of the gain is subject to tax; if there is a net loss, it is an ordinary loss, deductible in full.

Obviously, if a corporation wishes to dispose of two pieces of machinery, on one of which it will realize a $1,000 gain, and on the other, a $1,000 loss, it is most desirable to sell the assets in different taxable years so that the loss will be fully deductible and only $500 of the gain will be taxable. However, this is not always practical, and in some cases both machines must be disposed of at the same time. In such a case, it is advisable to consider abandoning the loss property (thus taking an abandonment loss in full rather than a loss on exchange of property) and selling the other machine at a profit. It is thus reduced to mathematics: the corporation will get a tax saving of 52% of the adjusted basis of the machine abandoned (less salvage value realized) and will pay tax on only $500 of the gain on the machine sold.

Pension Plans

Pension plans are most popular during the high tax years. The real growth of the pension plan program started during the World War II Excess Profits tax years. And in truth, the basic idea behind the plan was excellent. Since the contributions are deductible, the corporation could cement employer-employee relationships with the government paying the major portion of the bill; the employees were being provided for by accumulating reserves against the future without any tax to them.

However pension plans become quite burdensome in years of low profits. The contributions are increased as more employees are added to the plan; the amounts of contribution by the corporation are fixed by the terms of the plan at the time of adoption.

The plan cannot be discontinued without permission of the Commissioner,[14] and the policy of the Service has been that in order to obtain that permission it is necessary to pay the tax benefit obtained in prior years through such deductions, as part of the current year's tax. In addition, when the plan is discontinued, there is the risk of incurring the ill-will of the employees.

Therefore, when installing a plan in a small, "close" corporation, particularly one, the profits of which are subject to wide fluctuations, it is most important to weigh carefully the type of plan to be used. Sometimes a profit-sharing trust or plan may be much more advisable.

Corporation and Stockholder Transactions

A small closely held corporation can be used for many transactions to avoid

[12] Section 501 (a)(1), I.R.C.
[13] Section 117 (j)(1), I.R.C.
[14] Regulations 111, Section 29.165-11; P.S. 52, 57, 60.

taxes. To prevent this, Congress has tried to close the loopholes as fast as they have appeared.

In 1932, a gentleman by the name of John Thomas Smith used his solely-owned corporation as the method of realizing losses on securities he owned, yet still keeping control of them through his corporation.[15] The Supreme Court disallowed these losses under the *Gregory* doctrine. As a result, Congress enacted section 24 (b) in the Revenue Act of 1938, which provides, inter alia, that losses from sale or exchange of property between a corporation and an individual who owns, actually or constructively, *more than* 50% in value of the outstanding stock of that corporation, shall not be recognized. The constructive ownership rules are set forth in section 24 (b)(2).

At the same time there was enacted the famous "2½ months' " rule of section 24 (c), wherein no deduction is allowed for accrued interest or other expense payable to stockholders (as delineated in section 24 (b)(2)) which is not paid within two and one-half months after the end of the taxable year, and which is not includible in the gross income of the payee for his taxable year in which the corporation's taxable year ends.

Some relief has been afforded under the Technical Changes Act of 1953,[16] but the relief is remedial. The situation should be avoided in the beginning.

It is not difficult to avoid. All three of the conditions described in section 24 (c) must be present. The conditions are not in the alternative; they are conjunctive; if any one of them do not obtain, the deduction is allowable. The safest rule to follow is to pay within the two and one-half month period any accrual of expense payable to a stockholder who qualifies under section 24 (b)(2). And "pay" means just that. A credit to a stockholder's open account, or an offset will probably be contested by the Service.

Although losses on exchanges between the stockholders and their corporation have not been allowed since the enactment of section 24 (b), gains on such exchanges had been recognized as capital gains. By this means, it often has been possible to obtain a stepped-up basis on property which has appreciated in value while in the hands of the individual, and at the same time get money out of the corporation at capital gains rates. This loophole was closed with the enactment of section 117 (o) in the Revenue Act of 1951.[17]

Section 117 (o) provides that gain realized on the sale or exchange of depreciable property between a corporation and an individual, who owns more than 80% in value of the stock of that corporation, shall be treated as ordinary income. Again the stock ownership is constructive; but the attributions are different from those set forth in section 24 (b)(2). Under section 117 (o), the stock must be owned by the individual, his wife and/or minor children or grandchildren.

The dangers inherent in getting property into a corporation are matched by the involutions of the Code dealing with getting property out of a corporation.

For instance, section 112 (b)(7) was enacted to enable the tax free liquidation of corporations (particularly Personal Holding Companies and Real Estate Companies) under certain circumstances. Under this section, the capital gains tax on the appreciation of property distributed is postponed until the property is disposed of by the distributees. The purpose of this was to

[15] *Higgins* v. *Smith*, 308 US 473 (rev'g CCA-2, 1939).

[16] Section 202 of the "Technical Changes Act of 1953".

[17] Section 117 (o) is applicable to sales or exchanges made after May 3, 1951, effective for taxable years ending after April 30, 1951.

avoid the forced sale of the distributed property in order to pay taxes.

However, there is a pitfall in this seemingly altruistic provision. If at the time of liquidation there are accumulated earnings or profits in the company, to the extent of such surplus, the gain on distribution is taxable as ordinary income. The surplus involved, however, is not the balance sheet surplus, but the tax surplus. As one taxpayer found to his sorrow[18], there may be a great difference between the two, due to a forgotten tax-free capitalization of surplus in some prior year. Before an election is made to liquidate under section 112 (b)(7), surplus *must* be traced back to the inception of the corporation.

There has been some question as to how the application of the "tax-free" provisions of section 112 (b)(7) reconcile with the provisions of the section dealing with "collapsible corporations".[19] There the gain from sale or exchange, whether in liquidation or otherwise, of the stock of a "collapsible corporation"[20] held for more than six months is treated as ordinary income.

In this respect the attitude of the Service is that section 112 (b)(7) is applied first—but if the corporation qualifies as "collapsible" and if there is any income which would be treated as capital gain under section 112 (b)(7)[21] such gain will be treated as ordinary income under section 117 (m).

Stock Dividends

Stock dividends are now being closely scrutinized and, in many cases, vigorously opposed by the Service as to their non-taxable status. For many years the Treasury has felt that the *Eisner* v. *Macomber*[22] doctrine left too many loopholes for getting earnings out of the small closely held corporation without paying tax thereon. In order to carry out its program, the Treasury is no longer considering the stock dividend *per se* with respect to change of interest in the corporation or economic increment to the distributee; rather it is applying the "chameleon concept"[23] that the stock dividend takes on the color, tax-wise, of its purpose and ultimate disposition.

The Treasury has attacked dividends of preferred on common,[24] common on common,[25] preferred and common on preferred and common,[26] and preferred on preferred.[27] In all of these cases, the Tax Court has supported the Commissioner by looking "through" the transaction, by applying the "business purpose" test, and by rationalizing whether at any time subsequent to the dividend, the distributees have obtained any economic increment directly or indirectly attributable to the dividend. In all of these cases (with the exception of the *Messer* case, which has not been appealed) the determination of the Tax Court has been reversed in the Circuit Courts. Recently, the Commissioner has applied for certiorari to the Supreme

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[18] *Lewis B. Meyer Estate,* 15 TC 850.

[19] Section 117 (m), I.R.C.

[20] For definition of "collapsible corporation" see Section 117 (m)(2). For limitations on application of section, see Section 117 (m)(3).

[21] Section 112 (b)(7)(E)(ii).

[22] *Eisner* v. *Macomber,* 252 U.S. 189.

[23] "The Chameleon Concept" by Jacquin D. Bierman, 12th Annual N.Y.U. Institute on Federal Taxation (1953) p. —.

[24] *C. P. Chamberlin,* (CCA-6, 1953) 207 F (2d) 462, rev'g 18 TC 164.

[25] *Jos. Schmitt,* (CCA-3, 1954) — F (2d) —, rev'g 20 TC, No. 44.

[26] *Wiegand* (CCA-3, 1952) 194 F (2d) 479, rev'g 14 TC 136.

[27] *John A. Messer,* 20 TC, No. 31.

Court in the *Chamberlin* case. If it is granted, there may be some resolution of the present judicial conflicts. In the meantime, until clarifying legislation is enacted, the problem will continue to be a serious one.

Capitalization of Corporation

One of the primary problems in forming a small, closely held corporation is that of capitalization. The most desirable type of capitalization would be that with a minimum of investment in stock, and a maximum investment represented by loans to the corporation.

Payments for the use of the money or property invested is deductible as interest, if the investment is in the form of loans. However, if the money is paid in for stock, the dividends thereon are not deductible. Second, the repayment of a loan by the corporation when contraction of the liquid capital is desirable, is a means of getting money out of the corporation without tax consequences. Redemption of stock constitutes partial liquidation and partial liquidations are always suspect by the Treasury and are subject to severe scrutiny. Furthermore, loans outstanding, if bona fide, are a good basis for the non-distribution of dividends and a strong defense against the application of a penalty section 102 surtax.

If the corporation is unsuccessful, it may be that the investment cannot be repaid because there are insufficient assets after the settlement of claims of other creditors. There again, the "loan" is more advantageous than the "capital stock investment". If the loan cannot be repaid, it represents either a business bad debt (which is fully deductible) or a non-business bad debt (which is treated as a short term capital loss[28]). Furthermore, a loan can be determined to be partially worthless in a taxable year, while stock is never partially worthless for tax purposes.

If the loan is represented by a "security" as defined in section 23 (k)(3) (i.e., a bond debenture, note, certificate or other indebtedness issued by the corporation with either interest coupons or in registered form) which becomes worthless during the taxable year, it is treated as a capital asset sold on the last day of the taxable year.

If the corporation is successful, and it is determined to be advisable to contract its capitalization, there is no tax problem involved in the repayment of a bona fide loan. Partial liquidation of stock as has been discussed above, may result in a dividend taxable as ordinary income.[29]

It is impossible to give any rule of thumb ratio by which borrowed capital can safely exceed invested capital. The Commissioner has attacked ratios which were as low as 2½ to 1,[30] although in that case he was unsuccessful. In many cases, however, the Tax Court has supported the Commissioner.

In general, much has depended upon the actual facts in each case, and less emphasis has been laid upon the ratio test. Rather, the Court has stressed the following in the rationale of its determination: (1) Were the loans advanced in the same proportion as the stock holdings? (2) At the time of the advance, were the loans recorded on the corporate books as "loans"? (3) Were the evidence of the loans issued at a stated rate of interest (not dependent upon earnings) and did they bear a maturity date? (4) Did the obligee have the right to sue the corporation in the event of non-payment? (5) Were the evidences of indebtedness issued at the time the loans were made?

As is self-evident from the foregoing, upon the organization of a closely held corporation, it is equally important to consider, before determining upon capitalization, the eventualities which may arise during its existence and upon its termination.

[28] Section 23 (k)(4), I.R.C.
[29] Section 115 (g); See also *Zenz*, Dist. Ct. N. D. W. D., 106 Fed. Supp. 57.
[30] *Gazette Telegraph Co.*, 19 TC, No. 86.

Under the present set-up, it is far more difficult to get money out of a corporation without suffering tax consequences than it is to put it in.

In this connection, it is generally helpful if complete and accurate corporate minute books are maintained. Unfortunately, there has been a trend in the case of small corporations which are owned by one or two stockholders, or by a family group, to fill the minute books with "boiler plate" (generally consisting in the pre-printed forms which can be obtained at a legal stationery store). Such records are not adequate and have not been accepted by the Courts or the Commissioner as support for allegations or assertions advanced to avoid the various penalty taxes and tax pitfalls.

If a policy has been carefully thought out and adopted, it should be recorded in the minute book in such a manner as to clearly present its intent, its business purpose and the result expected to be achieved.

The Internal Revenue Code was devised for the purpose of taxing income. Its complexities have arisen because of the Congressional desire that the tax be equitable and, on the other hand, the Congressional intent to close all loopholes through which income that should be taxed might escape taxation. While these intents are not conflicting, to the unwary the various involutions represent dangerous pitfalls. Unless the many ramifications are carefully studied, considered and understood in their tax aspects, a transaction entered into in good faith can have disastrous results.

Note on the Reproduction of New York State Tax Returns

(Continued from page 160)

individual sheets comprising the completed return. The State will not accept such returns unless joined with extra heavy tape (Scotch polyester film tape No. 850, made by the Minn. Mining Co. or the equivalent of such tape has been specifically recommended). Ordinary Scotch tape, stapling or any other form of fastening will not be accepted. Both the Income Tax Bureau and the Corporation Tax Bureau have expressed strenuous opposition to stapled returns and may reject returns joined in that manner.

Fold

Whether practitioners use machinery which produces the complete return in one operation or individual sheets comprising a completed return, it should be noted that the final sequence of pages and position of the fold must exactly simulate the official State returns in all respects. Practitioners should note that Forms 201 and 205 fold at the side while Forms 42 C.T. and 3 C.T. fold at the top of the page.

Miscellaneous

The reproduction of the taxpayer's signature cannot be reproduced. Practitioners should note that they may *not* submit page 1 and 2 of Form 201 as a completed return even though they may not utilize pages 3 and 4 in the preparation of that return. If they use 201, the complete form (four pages) must be submitted.

The reproduction of State income tax returns will undoubtedly prove of great value to many practitioners. It represents an economy in time and in money and should serve to increase over-all efficiency in the preparation of returns. The approval given by the State Tax Commission has been specifically restricted to one year. If the experience of the Commission is poor because of the failure on the part of practitioners to adhere to the conditions upon which said approval has been issued, the Commission may revoke its consent to the reproduction of returns.

Current Trends in Accounting—V

By Leo Rosenblum, C.P.A.

Some Capsules Reflecting Modern Practices and Current Problems and Conditions

Auditing

Statistics in Accounting

Sampling, it is believed, "can supply much accounting information with sufficient precision, at a much lower cost, and in shorter time than is possible with complete enumeration," points out John Neter, assistant professor of Business Statistics and Accounting at Syracuse University.[1]

"In a majority of instances in controlling and planning business operations," notes Dr. Neter, "management does not need 'perfectly accurate' data."[2] Figures within a certain percentage of this absolute position are suitable for such situations. Therefore, "why should one spend extra money to obtain 'exact' data when approximate information is sufficient?"

Ascertain, this writer suggests, what degree of precision is required. If, for example, in certain situations a 1% error is "tolerable" and in others a 10% error, determine what method will provide the information with the required precision at the lowest cost.

Dr. Neter quotes E. S. Root, director of research for the Erie Railroad:[3] "Accountants, by training, have a natural aversion to anything less than a 100% collection of data. Yet, in many instances, the volume and the cost of collecting railroad statistics either lead to methods that produce results of no greater accuracy than sound sampling would provide at far less cost, or desirable and needed data are not collected."

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"The Requirements . . . Appear to Go Beyond Normal Auditing Practice"

Occasionally there is conflict between the special rules of particular organizations and normal auditing practice. Here is an illustration.

A British "friendly society"[4] had rules outlining in detail the manner in which an audit was to be carried out. A member of the Institute of Chartered Accountants in England and Wales qualified his audit report, indicating that he "had not complied fully with

[1] *The Controller*, Vol. XXI, No. 8, August, 1953, pp. 369 *et seq.*, at p. 395.

[2] *Ibid.*, p. 369.

[3] *Ibid.*, p. 370.

[4] The nearest American equivalent, inquiry reveals, would be a fraternal organization, organized under the lodge system. This account of "friendly society" audit problems is based upon "Approved Auditors", in *The Accountant*, Vol. CXXVIII, No. 4096, June 20, 1953, p. 740.

the duties required of an auditor under the rules of the Friendly Society." The auditor and the Society agreed that the latter's Registrar inquire of the Association whether the requirements posed under the Society's rules "go beyond normal auditing practice." The following is an abstract from the statement authorized for publication by the Council of the Society:

> The Registrar has been informed that the Council considers that, where an audit is to be carried out by a qualified professional auditor, it is inappropriate that the rules of a Society should include regulations as to the manner in which the audit is to be carried out. The detailed work to be done by an auditor must always be a matter for the auditor to decide after he has examined all relevant facts including the bookkeeping system and method of internal check in operation. The responsibility accepted by the auditor is indicated by the terms of the report given by him; and if in any particular case it should be alleged that, through the auditor having failed to fulfil his responsibility, the Society has suffered a loss, it would be for the auditor to show that the work done by him was sufficient in scope and nature and was done with sufficient skill to support the terms of the report given by him.
>
> The Registrar has also been informed that although each case must be considered on its merits, the requirements of the rules of the Friendly Society in question appear to go beyond normal auditing practice, particularly one of the rules which implies that the auditor must communicate with every borrower and another rule which requires the auditor to communicate with every member.

No Guarantee

In a paper on "Principles or Profits" by F. E. Trigg, Australian chartered accountant, delivered before the Newcastle and Hunter Valley Conference of members of the Institute of Chartered Accountants in Australia, last Spring,[5] appears this note:

> "In my view the greatest misconception that has arisen is that the audit is a guarantee that everything in the accounts is right and that it is a complete safeguard. . . . [A]n audit is not, and never has been, anything more than a test which, if properly planned and developed, will secure reasonable protection at a reasonable cost. If this were not so, every transaction in a company's books would have to be checked and it is obvious that not only would the cost be prohibitive but limits to the physical capacity of auditors would make the task impossible."[6]

Therefore, Mr. Trigg points out, "the planning of the audit . . . is of great importance;" it entails "a proper balancing of benefits and risks against the cost involved." The auditor must examine the systems of bookkeeping and of internal control thoroughly; the scope of his audit will depend upon the result of the examination he makes.

Reports

Statement Presentation

The Research Department of the American Institute of Accountants has issued its seventh annual survey of corporate annual reports. Titled "Accounting Trends and Techniques in Published Corporate Annual Reports," the 303-page work ($10.00) reflects the "accounting aspects of 600 corporate annual reports" as well as excerpts from, and comments upon, some 700 additional reports. This authoritative compilation answers many troublesome questions concerning form, content, and terminology in statement presentation. Well-worth consulting, it should be available in every accountant's office for reference.

Here are a number of points noted on inspection of the work:

Retained earnings

Has the use of the term "retained earnings," or some similar term, in place of "earned surplus" gained any headway in recent years? Decidedly! Of the 600 companies studied over a 7-year period, just about one-half now refer to *retained, accumulated,*

[5] *The Chartered Accountant in Australia,* Vol. XXIII, No. 11, May 20, 1953, pp. 635-649.
[6] *Ibid.,* p. 641.

or *reinvested* (or some minor variant) earnings (or income or profit), in contrast with the term "earned surplus", which was employed by some 90% of the companies in 1947.[7]

Depreciation

The term *reserve* (for depreciation), formerly used in the balance sheet, is likewise being replaced by such words as *accumulated* or *allowance*. In 1952, 259 (43%) of the 600 companies studied used the new term in contrast with the 113 (19%) which did so in 1948.[8]

Post-balance sheet disclosures

The editors report that "The 1952 report of Boeing Airplane Company was the only . . . report [covered in the basic 600 company survey] in which there was a disclosure of events occurring subsequent to the balance sheet date." However, *Accounting Trends and Techniques* cites one of the supplementary reports, that of United States Tobacco Company, where the independent auditors include in their certificate or opinion reference to a sale of $8,000,000 of sinking fund debentures in January, 1953 (the company operating on a calendar year basis), and the application of the proceeds to the payment of notes payable to banks.[9]

Inventory reserves

Of the 600 companies, 127 provided inventory reserves.[10] But the placement of these reserves varied, being shown, variously, with the inventory; in the current liability section; above the stockholders' equity section; within that section in the notes to the financial statements; in the letter to stockholders.

What were the announced purposes of the reserves? Those stated were:[11] possible future inventory price decline; obsolescence in inventory; basic LIFO inventory replacement; basic inventory replacement—not LIFO; reduction of inventory to LIFO cost basis; reduction of inventory to cost basis—not LIFO; intercompany sales, discounts, profits; materials or supplies adjustments; shrinkage; reduction to market; inventory markdown, container valuation, crop hazards; loss on returns; overhead in inventory.

Statements for Bankers

"Dependability in Financial Statements" is the title of an article in a recent issue of the magazine, *Banking*,[12] by R. G. Rankin, C.P.A., of our Society.

"Before financial statements of business concerns issued by independent accountants became so popular in the business world," notes Mr. Rankin, applicants for bank loans presented figures "on the bank's own form for financial statements;" in other cases, "someone directly associated with the business enterprise" submitted statements which he had prepared. The statements, whether falling within the first group or the second, were signed by the proprietor of the business, a partner, or an officer of the corporation, and the signer "accepted responsibility for the financial statements."

In recent years, however, the situation has changed. Now borrowers and prospective borrowers supply the lending banks with the financial statements prepared by independent accountants,

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[7] American Institute of Accountants, "Accounting Trends and Techniques in Published Corporate Annual Reports" (7th Ed., New York, The Institute), p. 29.

[8] *Ibid.*, p. 22.

[9] *Ibid.*, p. 293.

[10] *Ibid.*, p. 79.

[11] *Ibid.*, p. 78.

[12] Vol. XLVI, No. 5, November, 1953, pp. 34, 130, 132-133.

chosen, as a general rule, by the borrowers. The loan officers "ordinarily accept such statements without the borrowers' assuming any direct responsibility for the reasonable correctness of the financial statements."

Two factors have brought about this change. "One . . . is the importance . . . attached to the term 'independent accountants', . . . professional men who presumably are not, and cannot afford to be, unduly influenced by the whims or desires of management when it comes to reporting correctly the financial condition and earning record of business concerns and other enterprises in financial statements issued by them."

The second is the development of the American Institute of Accountants' bulletins on "accepted accounting principles" and "accepted standard auditing procedures", the " 'Bible' on those two complex subjects" among CPAs.

These are the types of statements and audit reports likely to be found in banks' credit files:[13]

1. Statements on accountants' stationery, "without comment, opinion or signature."

2. "Audit reports . . . prepared without verification of the accounts and records supporting the statements;" also, those which "leave to the imagination of the reader the extent, if any, to which the accounts and records . . . have been examined."

3. "Audit reports . . . prepared for 'management purposes only'."

4. Long form reports.

5. Short form reports, "often loosely designated as the certificate."

Mr. Rankin discusses in some detail the procedure a loan officer should follow when reports of the various types are presented; "welcomed by all credit grantors and investors," he observes, are the reports in the fifth category.

Ethics

The American Institute of Accountants' Committee on Professional Ethics reports that it has received queries, from time to time, concerning the propriety of the reproduction in the local press of CPAs' special reports or statements "certifying" to the cost of merchandise on sale, or recommending that inventories be reduced.[14] The Committee considers the publication of such reports as undignified and not in the profession's best interests.

Logs in the Pond

Here's a quotation from the "Notes to the Balance Sheet," in the annual report to stockholders of a mid-western coal and coke corporation:

> *"Valuation of Inventories:* In view of the impracticability of taking or verifying a physical inventory of logs in the pond, we made only a casual survey of this inventory and accepted without further verification the quantity of logs as shown on the Company's perpetual inventory records."[15]

Some Practical Problems

At the September meeting of the Massachusetts Society of CPAs, these three — among other — practical problems were discussed: change in the requirements, by the client, during the audit; discrepancies in the value of inventories acquired from the estate of a decedent; deferred development expense.[16]

In the first case, after a long discussion with management, the accountants decided to qualify their report.

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[13] *Ibid.*, pp. 130, 132.

[14] *The CPA*, membership bulletin of the American Institute of Accountants, October, 1953, p. 10.

[15] On the subject of difficulties encountered in verifying inventory, consider "What Was in the Tank?" in *"Current Trends in Accounting—III,* in *The New York Certified Public Accountant,* Vol. XXIII, No. 8, August, 1953, pp. 507-508.

[16] See "Three Practical Problems," in *News Bulletin* (of the Massachusetts Society of CPAs), Vol. 27, No. 3, November, 1953, pp. 10-15.

In the second, the auditors' opinion included the statement that they could not pass "on the cost of goods sold or upon the overall results of operations for the year," because, among other problems, "neither the auditors nor the management had any real knowledge just what inventory had been acquired" from the estate of a decedent. The third case illustrated the advisability of deferring certain types of development expenditures only in situations where the expenditures "will be productive of future earnings."

A.R.B. 29

"Has A.R.B. 29 Settled the Problem of Inventory Valuation?" asks Nathan Seitelman, C.P.A., in an article of that title in *The Accounting Review*.[17]

There is "a lack of uniformity among practitioners and non-adherence to Statements 5 and 6 of A.R.B. No. 29 in valuation practices," he points out.

Dr. Seitelman suggests, as a solution to the "century-old problem of inventory valuation," that: (1) inventory be valued at cost, "with a surplus reserve clearly earmarked for valuation purposes" to reduce inventory to the basis the accountant considers necessary; (2) when price levels are declining, inventory be valued at the lower of cost or market, market "not to exceed the ceiling . . . in Statement 6(1) of A.R.B. No. 29."

The British Approve

In the Finance and Commerce section of the British magazine, *The Accountant*,[18] appears this enthusiastic comment, pointing up the difference between the degree of detail in financial figures found in American corporate reports to stockholders as compared to those made available in the United Kingdom. To quote the item:

> "The company's [Crown Zellerbach Corporation's] example in providing its shareholders with quarterly figures, and, what is more, with figures right the way down from sales to net income on the common stock stock may . . . nudge some companies into action over here."

The columnist also commends "the mental approach in America [which is] to prompt and frequent company reporting as against the annual figures, or from four, five and six months and more old, as presented in this country."

Qualified Report: Depreciation

The Accountants Journal[19] reports this unusual controversy between a company's directors and its auditors. The problem related to a question of company law interpretation and was revealed on inspection of the auditor's report on the 1952 accounts of Henry Boot & Sons, British public works contractors.

The Accountants' report reflected this qualification:

> "In our view the accumulated depreciation provided on building and land[,] etc.[,] is in excess of requirements."

The company's balance sheet, dated December 31st, showed buildings and plants costing £487,000 to have been written down by £371,000, "a more than adequate provision."

The *Journal* points out that the Companies Act, 1948, states that "where any amount written off or retained as provision for depreciation, renewals or the diminution in value of assets is in excess of what is reasonably necessary, the excess shall be classed as a reserve and not a provision," the object of this provision being "to prevent any heaping up of undisclosed reserves."

But, asks the *Accountants Journal*, "who is to decide whether an accumulated depreciation is excessive?"

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[17] Vol. XXVIII, No. 4, October, 1953, pp. 550-553.

[18] Vol. CXXIX, No. 4114, October 24, 1953, p. 478.

[19] "Financial Notes" column, Vol. XLV, No. 548, October, 1953, p. 300.

Too Conservative

In a most witty and entertaining talk before a luncheon of the London and District Society of Chartered Accountants, on November 3, 1953, the Rt. Hon. Oliver Lyttelton, member of Parliament, discussed "Accountancy and Company Finance." [20]

Considering the valuation of going concerns, he ribbed his audience with the comment: "Chartered accountants' valuations of going concerns are matters which should be dealt with by the company director with great circumspection. I have never sold a company upon a chartered accountant's valuation; I have bought many."

Practitioners' Problems

Advisory Committee

The 1954 AIA meeting will include an all-day session on the problem of the "local practitioner".[21]

Five new sub-committees of the Advisory Committee of Local Practitioners have been formed. They will deal with: fee surveys by state societies; Statement 23; compensation of correspondent auditors; standard procedure manuals; member relations.

Bank Confirmations

Have you seen the new AIA-sponsored bank confirmation form? Designated as *Form 1953*, it replaces *Forms 1940* and *1940A*, in use since 1940. The new form, endorsed by the National Association of Bank Auditors and Comptrollers, is sized 8½" x 11" for convenience in filing.

Teaching Professional Ethics

The Education Committee of our Society suggests that more time be devoted to teaching professional ethics than is being applied at present in accounting schools.[22]

Copies of the Society's rules of professional conduct as well as those of the American Institute of Accountants and our state are being sent to all of the colleges whose professional accountancy courses have been approved by the state.

Staff Training; Discussion Topics

"The steady growth of the accounting profession to its position of eminence today owes much to improvements in staff training," notes Edward M. Boulter, CPA, of California.[23]

The development of staff training programs, he points out, is equally significant to both large and small firms.

Important considerations to applicants for positions with public accounting firms are the training and experience offered by the prospective employer.

Training programs, Mr. Boulter notes, generally fall into these two classes: first, on-the-job training; and second, group discussion meetings or lectures. The former includes these activities: introduction to the job; work assignments and instruction; review of the trainee's work; encouragement of staff development and advancement. The discussion group or lecture technique involves: planning and organization; discussion leadership; careful consideration of conference techniques; careful selection of topics for discussion.

Here is a list of discussion topics suggested by Mr. Boulter; they will stimulate constructive thinking on staff problems:

Audit planning and administration; auditing techniques; consolidations; cost accounting; duties of staff members;

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[20] *The Accountant*, Vol. CXXIX, No. 4119, November 28, 1953, pp. 601-604.

[21] AIA *Newsletter*, Vol. 4, No. 9, December, 1953, pp. 1-2.

[22] *CPA News*, Bulletin of the Society, Vol. XV, No. 5, December, 1953, p. 2.

[23] "The Increasing Importance of Staff Training," in *The Canadian Chartered Accountant*, Vol. 63, No. 4, October, 1953, pp. 159-165, at p. 159.

federal income taxes: current developments, preparation of tax returns and work papers, review of estimated tax liability, use of tax services; financial statement preparation; firm policies; foreign exchange; fraud cases; instruction in operation of business machines; insurance coverage; internal control and accounting procedures: correlation with audit procedures, review and report to clients, system work; LIFO inventory problems; office organization and files; pension accounting; permanent files; preparation of audit work papers; reduction of time charges through refinement of auditing procedures; renegotiation; review of work papers and report; SEC matters; specialized industry problems: writing reports, memoranda, letters and notes.

Auditing Machine-kept Records

S. M. Meyers, CPA, of Cleveland, Ohio, is the author of a series of two articles reciting the "Experiences of an Auditor with Punched Card Accounting".[24] Mr. Meyers presents a step-by-step description of audit procedures for accounts receivable, inventories, accounts payable, general ledgers, and property records.

He also discusses some features of the audit of a brokerage house whose accounts were kept through the use of punched cards.

Fees and Billing: A British Note

R. Sproull, chartered accountant, discusses the subject of "Organization and Fees in Medium Practices" in *The Accountant*.[25] He considers the number of productive days available to the accountant and how the time should be planned. Referring to a "job . . . control for accounts work" and another for "non-accounts work", he suggests classifying the types of work undertaken by the auditor, with variations in the billing rate for these classes of work. The procedure for setting up a client service time ledger is also outlined. Most interesting is Mr. Sproull's section on "charging rates", including the use of a charging rates formula for staff and principal.

"Should slack season work be billed at lower scales?" he asks. "Should allowances be made from bills?" If yes, should they be shown on the bill, or given after the bill is rendered, or through the medium of writing off bad debts? "Are fixed fees proper?" "Should one consider the client's ability to pay?" These and similar matters, discussed at length, will render profitable your review of Mr. Sproull's paper.

Isolation

James Blakey, chartered accountant, president of the Institute of Chartered Accountants in England and Wales, made these comments at the Institute's 14th Annual Dinner on November 6, 1953, in Brighton, England:[26]

> "the smaller practitioner suffers from . . . [this]: . . . the isolation . . . when he feels the need for a talk with a colleague on a difficult matter. Not unnaturally, he hesitates to approach a fellow practitioner because he may think that this will result in . . . losing a client. Personally I do not think that this applies, I am sure there must be friends near at hand who would be prepared to help with advice. If not . . . there is an advisory committee of each district society, to which he may apply for informal advice when confronted with a difficult question of practice."

In this connection, members of the Society are reminded of the availability of our Society's Director of Research and Technical Services, through whom the Society offers its facilities for obtaining responses to questions on practice and procedure.

No Commission on Overseas Engagement

The Public Accountants and Auditors Act passed about two years ago by the South African Parliament prohibits (Section 30) accounting firms

[24] *The Hopper*, publication of the National Machine Accountants Association, Vol. 4, Nos. 9 and 10, October, 1953, pp. 2-6, and November, 1953, pp. 8, *et seq.*

[25] Vol. CXXIX, No. 4098, July 4, 1953, pp. 8-13.

[26] *The Accountant*, Vol. CXXIX, No. 4117, November 14, 1953, p. 61.

from practicing in the Union of South Africa "under firm names which include . . . [those] of partners who are not and have not been resident there".[27] Also prohibited is the "passing of commissions between the South African branches of international firms of accountants and their overseas principals."

But, at the last moment of the legislation, operation of these provisions was suspended for five years. The Public Accountants' and Auditors' Board began an inquiry into Section 30 in June, 1953, adjourning its hearings for fresh evidence.

South African opinions on Section 30 are mixed; accordingly, it "cannot be forecast whether the international firms — which include a number of large British firms of accountants — will be excluded from practising in the Union under their firms' names" in three years, or whether Section 30 will not be put into effect.

Taxes

Traveling Expenses

In the November, 1953, issue of *News Bulletin*, publication of the *Massachusetts Society of CPAs*[28], Frank Levenson, CPA, discusses the "Major Aspects of Traveling Expenses in Federal Taxation." He points out the requirements which must be satisfied to permit deductibility of traveling expenses as trade or business expenses; clarifies and comments upon the definition of the term "home" as employed by the Tax Court; considers travel away from home; examines the definition of "trade or business"; discusses the status of the independent contractor as against that of the employee; and also reviews at length the subjects of the reimbursement of expenses in connection with employment, withholding and reporting on expense allowances, and non-trade or non-business expenses.

Finally, Mr. Levenson reviews the various aspects of traveling expenses as charitable contributions, medical expenses, and personal or capital expenditures.

Entertainment Expenses

Entertainment expenses are "strictly business" now, points out Prentice-Hall, Inc., in its "Accountant's Weekly Report" for November 23, 1953.[29]

An industrial physician, whose clients were corporations and their insurance companies, and who was president of the county medical society, made claim for certain deductions as "promotional" expenses. The items included: (1) Flowers to nurses and gifts to elevator operators, parking lot attendants and hospital employees; (2) Hunting trip; (3) Gifts to medical associates; (4) Expense of reprinting and mailing an article on Industrial Surgery, sent generally to the profession as well as prospective clients; (5) His own lunches at the Chamber of Commerce and Hospital Association; (6) Entertainment expenses for other physicians and community leaders; (7) Maintenance and depreciation on a cabin cruiser, used for entertainment.

The Tax Court disallowed each of the first five items. As to items 6 and 7, it allowed 25% of the other entertainment expense and of the cabin cruiser expense.

Traveling and Entertainment Expenses: Great Britain

British taxpayers' difficulties are discussed at length in the "Leaves From The Notebook of a Professional Accountant" section of the magazine *Accountancy*.[30]

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[27] *Accountancy*, Vol. LXIV (Vol. 15 New Series), No. 720, August, 1953, p. 248.

[28] Vol. 27, No. 3, pp. 1-8.

[29] Vol. 12, No. 10, pp. 1-2.

[30] Vol. LXIV (Vol. 15 New Series), No. 723, November, 1953, pp. 356-360.

Rarely does it happen, observes Ernest Evan Spicer, chartered accountant, conductor of the column, that the authorities "do not attempt to whittle £5 or £10 off perfectly justifiable expenses, on the ground that some of the items are estimated (as if a busy man can be expected to keep an exact record of every penny spent) or because the claimant is deemed to have enjoyed some slight benefit out of the expenditure." He cites the case of a prominent surgeon who was invited to attend an International Congress of Surgeons in New York City. There he was to deliver a course of lectures and to perform operations, to make his methods available to surgeons from other nations.

Of course, there was no compensation—nor any suggestion that traveling expenses would be reimbursed.

The Inland Revenue authorities did not consider the expenses a proper deduction from income. They "distinguish sharply between expenses incurred with the object of . . . *imparting* knowledge and expenses incurred with the object of *acquiring* knowledge" (emphasis added).

Mr. Spicer points out that the expenses of a young surgeon (who had worked under the surgeon discussed above), who attended the Congress in order to listen to the lectures and witness the operations, were allowed on the ground that they were incurred solely with the object of acquiring knowledge. Further, the Inland Revenue authorities informed the older surgeon that if, while in America, he attended lectures by other medical men, watched operations performed by others and visited hospitals, they "would consider what proportion of his total expenses, if any, could . . . be treated as charged against his professional earnings."

The above account confirms, again, our observation that tax problems are the same the world over.

Tax Accounting vs. Accepted Accounting Principles

The Institute's Committee on Accounting Principles for Income Tax Purposes has prepared a pamphlet called "Report and Recommendations with Respect to Divergences between Tax Accounting and Generally Accepted Accounting Principles." It was submitted to the Hon. Daniel A. Reed (R., N. Y.), Chairman of the House Ways and Means Committee, on December 10, 1953.

The Committee stated its belief that "the enactment of new legislation is necessary in order to eliminate divergences such as those described" in the report. The Committee's long list of "typical cases where rules of tax accounting require treatment contrary to generally accepted accounting principles" is classified under these headings: divergences involving the time of recognition of revenues; those involving the time of allowance of deductions; those involving inventories and purchase commitments; and those involving recognition of gain or loss.

Ethics: "Client . . . Evaded the 'Revenue Net'"

This question is raised by one of *Accountancy's*[31] correspondents.

> "I am interested in the question whether an accountant should prepare accounts and balance sheet for a client when he knows that the client has evaded the 'Revenue net' for a considerable time. In the case in point the accountant has instructions to prepare accounts for the business but he is *not* instructed to deal with the tax affairs.
>
> "Should the accountant refuse to act for the client when he knows there is an undeclared tax liability?"

The publication offered this answer:

> "Without knowing all the facts it is difficult to give an opinion, but taking a general line, it is surely better that the accounts should be right than that nothing should be right! How can the accountant be sure that there is tax evasion? It may

[31] In "Readers' Points and Queries", Vol. LXIV (Vol. 15 New Series), No. 722, October, 1953, p. 336.

be that proper accounts may set in motion the machinery for putting the whole affair in order."

Tax Problems Are the Same the World Over: India

The Federation of Chambers of Commerce and Industry (of India) has suggested to the Taxation Enquiry Commission consideration of these points, among others:[32]

(1) Is the existing level of taxation in income such as to hinder the required rate of capital formation?; (2) Should the existing system of allowances for depreciation be revised so as to promote industrial rehabilitation as well as to keep industry's fixed assets intact?; (3) Should the existing laws relating to taxation be simplified and codified?; (4) Should uniformity in sales tax administration be secured by the centralization of sales tax to reduce avoidable hardship to trade and industry?; (5) Should the incidence of taxes levied by central, state and local governments be considered?; (6) Are those taxes utilized for the purposes for which they were levied?

Aids for Clients

Accounting for Repair Costs During the Guarantee Period

What does it cost your client to repair products sold under a guarantee or a warranty? With the increase in the number of consumer products made available under guarantee of free repairs during a limited or long period, the determination of the cost of such guarantee is, of course, important.

How does your client keep track of his repair cost? What records does he use? Is he in position to distinguish the cost of repairs under a one year warranty from those under a two to five year warranty or under an exchange plan or a flat-rate repairs arrangement?

A procedure for determining the cost of each class is outlined in "Accounting for Costs of Returned Product Repair Under a Decentralized Plan" by C. M. Bowen (senior accountant of the Comptroller's Staff, York Corporation, York, Pennsylvania), in *Cost and Management*.[33] Mr. Bowen also presents facsimiles of an inspection report and a return material order.

Leasebacks

In the September, 1953, issue of *The Controller*,[34] appears a report on leasebacks versus security financing, prepared by a subcommittee of the Committee on Capital Assets and Related Reserves of the New York City Control of the Controllers Institute. The factors determining whether a given property should be owned or leased, the tax benefits, and the effect on working capital are all considered.

Also provided is a most important check list of the factors influencing selection. It covers long-term stability of earnings, costs, financing, and adjustability to changing conditions. In addition, the report includes a chart covering the salient features of Tax Court cases on the subject of sales and leasebacks.[35] The latter deals with the details of sale, including the relationship, if any, between seller and buyer, the nature of the property, the price, the basis at the time of sale, the loss or gain on the sale, the method of determining the sales price and the manner of payment, and the details of the lease.

What Are the Competitors Doing?

"Every cost accountant," says Hermann C. Miller, CPA, Chairman and Professor of Accounting at the Ohio

[32] *The Indian Accountant*, Vol. XXV, No. 2, New Series, May, 1953, pp. 25-26.

[33] Vol. XXVII, No. 10, November, 1953, pp. 413-421 (Official Journal of the Society of Industrial and Cost Accountants of Canada).

[34] Vol. XXI, No. 9, pp. 413-420.

[35] Pp. 419-20.

State University, "should be technically capable of telling management what costs are, what they have been, and what they ought to be."[36]

But there is another job for the cost accountant, namely, measuring the costs of competitors' products. The cost accountant, the professor notes, has an organizing task; he must recruit a team of willing and cooperative associates.[37] Salesmen will provide data concerning the products, the prices and competition offered in each area; the purchasing agent, the prices of containers and materials and the sources from which they are available; the traffic department, transportation costs; the industrial relations department, facts on labor costs. "Secrets don't remain secure for long;" thus variation in production methods would be known to the production department.

With all of this information available the cost accountant should be able to aid in the measurement of the costs of the competitors' products.

Electronics

What electronic equipment is available for bookkeeping and accounting work? What does it cost? How can it be adapted to your clients' work? The answers to these and related questions are provided in a down-to-earth, practical explanation of the prospects offered through the use of electronic equipment, in W. P. Livingston's recent paper in *The Internal Auditor*.[38] The paper was delivered at a regional convention of the Institute of Internal Auditors in Toronto, Canada; the author is an assistant vice president of Bankers Trust Company, of New York City.

Describing the types of equipment available, and what they can do, Mr. Livingston cautions that analysis and standardization are essential in planning any electronic installation. Further, these three procedures must be followed: decide what end is sought; then, in step-by-step detail, work out the program; finally, code the source information in such fashion as to activate a machine.[39]

Financial Advice

K. A. E. Moore, chartered accountant, discusses "The Accountant as Financial Adviser" in two papers in *The Accountant*.[40]

Mr. Moore hits on a point on which many businessmen are in agreement, namely, the importance of the accountant's advice. He reports this remark made by a person, not an accountant, "who holds a distinguished position in the City of London":

> In my earlier years I often had experience of boards coming to wrong decisions because they had only half the story before them. Nowadays I always see to it that there is a chartered accountant on all my boards, not because he is necessarily wiser than any other person of experience in considering matters of policy, but because a chartered accountant, by his training, seems to have a flair for ensuring that all the material facts and considerations are before a board when they are making up their minds on an important matter with a financial angle to it.

Standard Costing in Small Factories

Frederick G. Beard, chartered accountant, of Durban, South Africa, has prepared a paper on the subject of standard costing in a metal window factory.[41] He outlines the computation of standard material cost and standard labor cost, concluding:

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[36] *Cost and Management*, Vol. XXVII, No. 10, November, 1953, pp. 409-412, at p. 409.

[37] *Ibid.*, p. 412.

[38] "Automatic Accounting Machines," Vol. 10, No. 4, December, 1953, pp. 31-39.

[39] *Ibid.*, p. 34.

[40] Vol. CXXIX, No. 4113, October 17, 1953, pp. 430-433; No. 4114, October 24, 1953, pp. 471 *et seq.*

[41] *Ibid.*, Vol. CXXIX, No. 4118, November 21, 1953, pp. 569-570.

"Although the explanation of this system must perforce be brief, it is hoped . . . that the inherent simplicity and complete adaptability of standard costing is clearly shown, thus 'debunking' its alleged complexities and exploding the fallacy . . . that standard costing 'won't work in *my* factory.'"

General

Movies

Designed as an aid in recruiting students for our profession is a recently completed sound movie called *Accountancy: The Language of Business.*[42] The film is available for showing, without charge, through Association Films, Inc., 79 East Adams Street, Chicago 3, Illinois.

"You Reduce Our Work and Our Fees"

Donald M. Russell, CPA, of Detroit, member of the firm of Lybrand, Ross Bros. & Montgomery, discussed the subject of "Coordination between Independent Public Accountants and the Internal Auditing Department," before the Sixth Annual Mid-West Regional Conference of the Institute of Internal Auditors.[43]

Public accountants, notes Mr. Russell, "encourage internal auditing." We are:

"anxious to cooperate and assist the development of internal auditing and to increase the prestige of Internal Auditing Departments in their respective companies. You [the internal auditors] reduce our work and our fees, but we welcome it . . . because we know that the successful operation of the total accounting and reporting job which the corporation has to do is done most efficiently and economically by cooperation"

between external auditor and internal auditor.[44]

Mr. Russell suggests that the internal auditors "should spend their time in auditing rather than in clerical work." The employees of the company's accounting department should aid the internal auditor by preparing trial balances, leading schedules and skeleton analyses for the internal auditors just as they do for the external auditors.

He cautions: "frequently . . . Internal Auditors are given special studies or emergency problems in line or staff accounting to such an extent that the time originally planned for auditing is not expended on auditing operations"; also, on occasion, internal auditing "is restricted to the general financial transactions, without getting close enough to the details of Cost Accounting."

Silence Is Golden

An editorial in the August, 1953 issue of *Accountancy,*[45] refers to the case of *Dean* v. *Prince* (3 W.L.R. 271, 1953), concerning the valuation of the shares of stock in a private company, left by a decedent. The articles of the company provided that on a member's death "his shares should be purchased by the directors at such price as was certified by the auditor to be in his opinion their fair value at the date of death and that in so certifying the auditor should be considered to act as an expert and not as an auditor."

Following the death of the individual who had held the controlling interest in the company, his shares were valued by the auditors. But the executrix challenged the validity of the auditors' valuation.

The executrix prevailed, the judge pointing out that the validity of the certificate could not have been challenged if the auditors had given no reasons for arriving at their valuation.

However, when the executrix pressed them, they explained the basis of valuation. As they put it in writing to her solicitors:

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[42] Noted in *The Journal of Accountancy,* Vol. 96, No. 6, December, 1953, p. 658.

[43] Reported in *L. R. B. & M. Journal,* Vol. 34, No. 5, September, 1953, pp. 10-19, 22.

[44] *Ibid.,* p. 11.

[45] Vol. LXIV (Vol. 15 New Series), No. 720, p. 246.

> "We enclose a few notes which we have prepared to show you how the points you raised have been allowed. . . . In view of these trading results [certain figures quoted in the last balance sheet] . . . it is clear that no value could be put on the shares on the normal going-concern basis other than something purely nominal. It became necessary, therefore, to consider the only other basis which could apply—i.e., break-up value."

The editorial writer points out that the valuation was wrong. The partner of the firm of auditors had testified that he adhered to the view that if the assets were sold at an auction they would produce £7 a share. Also, they could not have had a greater value than that even if valued on a going concern basis. This, however, completely ignored the fact that the shares under consideration reflected the controlling interest in the company; the company had made a trading profit over a number of years and was not in urgent need of being wound up.

Accordingly, the judge decreed that the valuation was not binding on the executrix.

Dean v. *Prince* is also discussed in *The Accountants Journal* for September, 1953.[46]

Goodwill

K. C. McQueen, writing on "Goodwill" in the *Australian Accountant*,[47] considers the various methods of arriving at appropriate valuation of the item. First, is trade or industry custom. Thus, in a bakery, for example,[48] goodwill is usually based on the number of bags of flour used per week. If the bakery uses fifty bags weekly, the goodwill is computed at 50 x 20, or £1000. Similarly, in dealing with a milk route goodwill is based on the number of quarts of milk sold each week.

A second method of goodwill computation is that based on profits. There are many variations of the method. For example, annual profits may be multiplied by a given factor, but estimated future maintainable profits must be considered.

Mr. McQueen reminds us that "the writing up of goodwill conflicts with sound accounting practice and there is general agreement it should not be contemplated. . . ."[49] This, he notes, presents the converse question, namely, whether goodwill should be written down, a point, he states, on which accountants disagree. Mr. McQueen himself believes that goodwill should be written off consistently over a long period.

Change the Spring CPA Exam Date?

At the October, 1953, meeting of the Association of CPA Examiners in Chicago, William H. Holm, vice-chairman of the State Board of Accountancy of the State of Oregon read a report based on a survey of the 53 CPA Boards in the United States and territories.[50] The survey showed that the boards desiring to retain the present May examination date were "a little in the majority" over those who wished a change to June.

The Michigan CPA,[51] for example, reports a suggestion that the state Association of Certified Public Accountants or its Board of Directors express their approval of the proposal to change the time of the Spring CPA examination from May to June, to permit June graduates to sit for the examination immediately after completing their courses. The Association's Board of Directors did not act on the suggestion: "there did not appear to be

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[46] Vol. XLV, No. 547, pp. 271-272 and 275-276.

[47] Vol. XXIII, No. 9, September, 1953, pp. 375 *et seq.*

[48] *Ibid.*, p. 376.

[49] *Ibid.*, p. 383.

[50] *The Oregon Certified Public Accountant*, Vol. 5, No. 2, November, 1953, p. 2.

[51] Vol. V, No. 3, November, 1953, p. 8.

any substantial support for the proposition."

Consolidation Accounting: British Practice

Accountancy[52] records these two suggestions on improving foreign procedures in accounting for consolidations, based upon suggestions made by the Incorporated Accountants' Research Committee in a pamphlet published in October, 1953:

(1) "In stating the results of a group the aggregate profits and the aggregate losses should be disclosed separately." Thus it would be impossible to "veil a trading loss made by one subsidiary and uncovered by its reserves." It is noted that the practice of stating only the net profit or loss of the group is permissible under the Companies Act. (In the United States, of course, the practice is to present in the annual report to stockholders, the consolidated balance sheet and consolidated profit and loss statement as well as the corresponding statements for the parent company itself.)

(2) "If a subsidiary makes [*sic*] a material loss, the directors of the holding company should consider whether to make a provision in the accounts of the holding company for depreciation of the investment in the subsidiary." (On this point, under American practice the loss would be reflected in the consolidated statements. But it would appear to be a matter within the discretion of the directors of the parent company whether adjustment through the provision of reserves was desirable.)

Centenary

The Institute of Chartered Accountants of Scotland will celebrate its Centenary this year. The celebration will extend from June 16 to June 18.[53]

Poll

Recently the Institute of Internal Auditors undertook a poll to determine what factors in the administration of an internal audit program must be recognized and stressed so that the activities of the internal audit department may have the greatest possibility of success.[54] Here, in the order in which they were deemed to be important, are the results of the poll: Competency and characteristics of staff members; acceptance and support of management and supervisors; organizational status; audit program concepts; staff policies; selection of staff; audit reports; training of staff; administration of staff; audit planning (schedules); conferences—prior to report issuance; outside accountants.

Work for an Accountant

In his book, "How to Organize and Manage a Small Business," Nels Black comments:[55]

> ". . . Most small-business men consider books and bookkeeping a nuisance and a chore. It is only human to shy away from the amount of detail involved and to avoid facing unpleasant facts which sooner or later turn up in any business. . . . [A] large proportion of small-business failures could be prevented if the proprietors either kept, or supervised closely, the keeping of *their own books* . . . ; many proprietors fail by their refusal to handle the jig-saw *details* necessary to piece together a clear and accurate picture of business performance."

What Others Think The Accountant Does

The Accountants' Journal, official organ of the New Zealand Society of Accountants,[56] reprints from "a recent

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[52] Vol. LXIV (Vol. 15 New Series), No. 723, November, 1953, p. 344.

[53] *The Accountants Journal*, Vol. XLV, No. 549, November, 1953, p. 318.

[54] Kent, Arthur H., "The Important Factors of a Successful Internal Auditing Program," in *The Internal Auditor*, Vol. 10, No. 2, June, 1953, pp. 7-27 (Talk delivered at meeting of Los Angeles Chapter, Institute of Internal Auditors).

[55] University of Oklahoma Press, 1952, p. 144.

[56] Vol. 32, No. 1, August 1, 1953, p. 14.

issue of 'The Professional Engineer'" an anonymous article about accountants, carried in the engineers' magazine under the title "What The Other Fellow Does."

Engineers consider the accountants ordinary human beings "whatever may be said to the contrary." With a few exceptions, we are reported to be "of the male species, ranging in age from very young, say 22, up to the very old, say 44." The engineers say that there are "several kinds of accountants," namely, the "public type, the unpublic type, the company-secretary type, and others who specialize in a really profitable side of the profession."

The public accountant "is usually to be found between the hours of 10:30 a. m. and noon and again between 3 p. m. and 5 p. m. in an office with a glass door."

They comment, humorously, "The accountancy profession is not the oldest profession in the world nor has it any dealing or practical sympathy with that profession," then observe that while the above are the "common or garden variety of accountants," there are other varieties, known as auditors, who "drop in unexpectedly on unsuspecting common types—or even on garden types—of accountants," carrying "a small rubber stamp and three pens, one charged with blue ink for ordinary annotations, one containing red . . . for special notes, and one . . . green . . . for making ticks."

The engineers conclude with the observation that to a good accountant, "balance sheets reveal all sorts of important information, such as why Jones cannot have a salary increase, why Brown, the engineer, must buy his own slide rule, why the production staff must be reduced, and why another bookkeeping machine will pay for itself in ten years."

Knowing the Facts and Figures Is Not Enough

Accountants generally come up with the right answers to accounting questions, but sometimes we lose out in making them understandable to clients. Some people say that we use too much accounting jargon; that our writing is stilted; that we are sometimes weak on human relations.

Several colleges have introduced courses in human relations designed especially for executives and professional men. The courses teach how to deal effectively with clients and staff members: how to listen; how to bring out the ideas of others; how to conduct conferences and interviews; how to invoke cooperation, avoid friction.

One of the local colleges, for example, offers courses in "Human Relations in Administration" and "Face-to-Face Communication for Executives;" also, a "Workshop in Executive Leadership."

Commercial Motion Picture Production Accounting

By Ben Dyer

This paper distinguishes commercial from theatrical production. It outlines operations common to all commercial producers; contracting approaches; script analysis; cost estimating; contracts, schedules and controls.

Contract versus Speculative Production

Commercial motion pictures are known by many names. They are called non-theatrical films, industrial films, business, advertising, training and 16mm films—to mention a few. Unfortunately, none of these labels apply in all cases or even generally. Non-theatrical refers to distribution, not to the film content, and applies to all exhibition regardless of where it is done, provided no admission charge is made. Some commercial films are on industrial and business subjects; some are, of course, training films; and there are many other classifications which may be made on subject matter or use. Of all the labels the most useless is that of 16mm films. Since 16mm is a size of film stock and no more, it does nothing to describe the content, use or type of the film. Most films are made in 35mm and the release prints are processed in either 35mm or 16mm, as required. Theatrical features are printed in 16mm for non-theatrical distribution and features have been shot in 16mm and blown up to 35mm for exhibition.

Ben Dyer is a consultant to motion picture producers, users and sponsors. He is a member of the Society of Motion Picture and Television Engineers and presented this paper at a recent technical meeting of our Society by invitation of the Committee on Graphic Arts and Allied Industries Accounting.

The real distinction between commercial films and others is purely financial. Regardless of subject matter, purpose, use, distribution or size of film, the commercial film is made to order on a contract basis for an individual purchaser. The purchaser may be an individual, a corporation, a church, association, university, a city, state or federal government, the armed forces or even some other producer. In all cases the commercial producer is a contractor making a product to order for a specified price. When completed, the film and all rights to its use, are the property of the purchaser. The commercial producer is not speculating, though he has the hazards of any contracting business plus some peculiar to motion pictures.

The theatrical producer is always a speculator. He invests his money (or his backers') in what he thinks the public will pay to see. He sells only entertainment to the public through renting his film to exhibitors. He retains all rights to the film and specifies when, where, for how long, and at what intervals it may be shown. His production costs bear little relation to his distributor's rental price for the film and no relation to how much profit he may ultimately receive.

There is nothing to prevent any producer from making both commercial and speculative films. Commercial films have been made by the well-known Hollywood theatrical producers, and theatrical features have been made by commercial producers on a contract basis for individuals with a story, the

money, and some idea of how they will get the film distributed theatrically. Commercial producers have also made speculative pictures, often in a series of 13 episodes to which various "commercials" may be added by TV stations for local sponsors. Often theatrical features contain a plug for some prominently branded refrigerator, automobile, radio or other product, for which the producer received either cash or free merchandise. And, just for the record's completeness, there is another type of film which may be called the subsidized feature. These films are built around the activities of some large corporation, the F.B.I., Treasury agents, or some branch of the armed forces, etc. In return for glorification of the activity, the producer receives a subsidy through the free use, and consequent large savings in production costs, of special equipment, offices, locations, personnel, etc., which would otherwise have to be built, rented or hired.

Although both commercial and theatrical pictures started at the same time, at present theatrical production is being curtailed but commercial film production is expanding rapidly. Commercial expansion is due to industry and government recognition of the powerful impact and flexibility of the film medium and the vast quantity of filmed material required by TV. The commercial field may be divided into union and non-union producers. The non-union producer is limited to the simpler types of pictures consisting largely of exterior locations, product demonstrations, simple "factory run-arounds" in non-union factories, etc. Pictures requiring large sets, professional talent, elaborate lighting, special effects, etc., demand union labor and facilities. There are many films which may be produced as well and more economically by non-union producers and when such a producer recognizes his field and cultivates it there is no reason why he cannot be successful. However, this paper will discuss only union operations.

Commercial Film Producers' Operations

Commercial film producers' operations have similarities to other contractors'. The sale is made before work begins on the product; the selling price is based on an estimate and stated in a contract; each job is different from the preceding job and the contractor's greatest asset is know-how. Like other contractors he may perform all steps in the work with his own staff and equipment or he may sub-contract portions of it. His staff will consist of a permanent nucleus which is augmented by temporary help obtained from various unions. In film production it is possible to rent all equipment and facilities and hire all talent and technicians required for any type of picture, by the day. Consequently a producer can be successful with a small capital investment provided he has large know-how. Such a producer has the advantages of low overhead, closer supervision of individual pictures and, because he is not obliged to keep a large staff and extensive facilities busy, greater freedom in selecting pictures to make. These advantages apply, of course, only to producers located in New York or Hollywood where all facilities and talent are available. Those located elsewhere may have to maintain larger staffs and own facilities because they are not available otherwise.

At the other extreme are those highly integrated commercial producers who own extensive plant-sound stages, recording studios, set-building shops and departments for art, animation, special effects, film processing, etc. Each additional facility acquired increases the overhead, not only for invested capital but for the necessary technicians to operate and maintain the equipment. The advantages of owning extensive facilities are largely confined to selling. Many film purchasers are impressed by displays of

equipment strange to them and the sign of many employees. The sales force can usually provide prospects with more presentations done on a speculative basis on what would otherwise be idle time for staff writers and artists. The high overhead resulting from maintaining extensive facilities often results in "high-pressure" selling tactics and attempts to get all the traffic will bear in prices.

Whether a producing company is small or large, or as most are, somewhere between the extremes, there is no "stock-piling" of product. To achieve a reasonable degree of efficiency, coordination between sales, production and financial management must be complete or idle capacity and excess overhead will result. In film production each of these principal divisions has some special problems in addition to their normal duties in any company.

The sales department has to sell a product to a purchaser (often called a client) who is usually grossly ignorant of what constitutes quality in the product, even though he may have purchased pictures before. The film medium is inherently expensive; the qualitative differences in production hard to describe and the producer's salesmen are usually facing people who, as representatives of large capital or power, are accustomed to having their own way. Some prospects will be long-term projects, requiring many interviews and considerable research before any results may be expected. Others will be sold on the use of films but must be sold on a particular treatment or producer. Contact must be kept with known purchasers of films—large corporations, the armed forces, associations, branches of the Government, advertising and television executives, etc. New prospects must be developed by "beating the bushes" for new contacts and suggesting uses for pictures to those not familiar with the medium's many varied uses. As large a list of prospects as possible must be kept "working" and a wide variety of selling methods employed. The entire selling effort must be applied intelligently, balanced between long- and short-term prospects for future and immediate business. Needless to say, the sales force should have sufficient knowledge of pictures, production costs and schedules to guide the client's thinking along lines that do not diverge from practical considerations of the picture's use, objective, prospective audience and budget.

The production department has to schedule personnel, equipment and facilities efficiently; exercise ingenuity in production; maintain good morale in the staff and good relations with many different unions. It must know each staff member's strong and weak points and have an answer for every problem—in advance for problems foreseen and instantly when unforseeable problems arise. Every union rule must be known and every custom in the industry. The cost of everything, literally, must be known and where it may be purchased, rented or hired. Scripts must be analyzed for production completely, estimated accurately and produced to budget. Production must cooperate with sales by developing ideas cinematically and providing treatments and sketches to crystallize client's vague desires and needs. Production must cooperate with finance by providing prompt payroll data, advance notice of heavy expenditures and of probable billing dates to clients for completion of the billing steps of the contracts.

The financial management is responsible for all of the usual accounting functions, seeing that all contract requirements, labor laws, insurance regulations, tax regulations, etc., are met. Flexibility and speed beyond that required in most business are required. Payrolls are weekly, but production crews must be paid off immediately upon completion of work—whenever that may be. Delays are so expensive in film production that the financial de-

partment must see that no delays are caused through lack of a check or cash when needed; that outside purchases and rentals are paid promptly and billings made promptly. This entails securing the "okays" of the production department for invoice amounts, time periods and contract completion steps. Cost accruals must be kept current so that frequent comparisons of accumulated costs and budget may be provided. The financial management must also maintain a balance between income and expenditures although both may be highly irregular. This necessitates cultivation and maintenance of a good credit position with its bank since film producers, like many other contractors, often regularly handle contracts in amounts greatly exceeding their total working capital.

Contracting Approaches

Because film costs are unfamiliar to them and seem high, there have been many attempts by frequent purchasers of films, such as government bureaus and advertising agencies, to reduce production costs to prices per "operation", or per reel, or per minute. These clients usually want an average price to pin down producers in advance for production of films not past the bare idea stage. Such efforts are as absurd as trying to get an average price for a building or a bridge. Certainly, all of the buildings in the United States could be tabulated and an average price per cubic foot established, but it would be of little value in pricing a new building. For instance an analysis of 18 commercial films shows the "average" price paid per reel was $12,000 but of the 18 only 3 were within $1,000 of the average reel price and the price per reel of the highest picture of the group was 21 times that of the lowest. And, for those who stress color costs unduly, I can add that although approximately 40% of this group were in color, both the highest- and the lowest-priced films were black and white. I recall a picture that averaged $13,000 per reel and consisted almost entirely of stock footage supplied by the client. The new shooting required by this picture totalled only four minutes in screen time but it required a full week of studio shooting and the scale models that were shot cost over $5,000 to build.

There are so many variables in subject matter, treatment, shooting complications and conditions and all other items in film production that the length of a film is a poor guide to its cost. Even pictures made under the same formula vary in cost. I remember a series of ten films made to the specifications of a government bureau. All were to be the same length, same format and similar treatment of various aspects of the same subject and were priced identically. A special unit was drawn from the staff of the producing company and they stayed with the job until all were finished. Despite all this uniformity, variations in shooting conditions and government supervisors resulted in cost differences as high as 50% of the per picture price.

Sometimes contracts are made on a cost plus basis so the producer can be required to prove every item of expense and charges can be debated before and after production. This method, when combined with an advertising agency writing the script as production proceeds, has resulted in some of the highest cost, low quality pictures ever produced. Another variation of contract approach is to give out a treatment to several producers for bids on production. Any price quoted on a treatment alone has to be pure guesswork, based either on what the producer thinks the client is willing to pay or some rule of thumb such as $1,000 per minute for a voice-over picture, and $2,000 per minute for a sync-sound picture.

At the other extreme are those trusting clients who sign contracts for a specified sum to include both script and production of the film. This is equivalent to ordering a contractor to build a house for a specified sum with-

out any specifications other than those he chooses to put in his plans. They get the right to approve the script, of course, but this means little in practice since few are capable of visualizing a finished picture from reading a script. They get a film, of course, which may or may not satisfy them depending largely on the producer's honesty, but it is unlikely that they will get the best picture in terms of what they need. The best solution for both film sponsor's and producer's difficulties lies in the services of an independent motion picture consultant. Independent means one providing specified services on a flat fee basis—not connected with an advertising agency or a producer. Such an unbiased consultant can prevent mistakes, eliminate misunderstandings and resolve the conflict of interests between buyer and seller with benefit to both.

Script Analysis

The basis of the production contract and the blueprint for the picture is the script. Although it is possible to make a bad picture from a good script, no good picture ever resulted from following a bad script. A purchaser of a picture should have a complete, detailed and specific script before any arrangements are made for production. This is not a simple step nor an easy one and it may take more time than anyone likes to spend. However, the better the script the better the picture and changes made in the paper stage are far less expensive than in the shooting stage.

The commercial film content includes all subjects, every type of production and every cinematic story-telling technique. Since the appearance of TV, this content has been expanded by new techniques to cope with TV's technical limitations and revival of old techniques used for cheap two-reel comedies, plus much subject matter from vaudeville and quiz shows, panel discussions, interviews and parlor games from radio. With this wide variety of content, know-how becomes more vital to the producer's success every day. There is, unfortunately, no way to acquire this combination of knowledge and abilities called know-how except by working on pictures, studying them, experimenting with them, analyzing each production step and living with pictures in a pressure cooker called a studio. Then, with his experience, if a person has sufficient imagination and visualizing ability to "shoot pictures in his head"—he has know-how. Please note that experience is not enough. No amount of experience benefits anyone unless he has the ability to learn, codify, formulate and utilize his knowledge and the imagination to project it into situations not yet experienced.

Given a specific script, regardless of content, it is possible to make a script analysis with as much precision as the "bill of quantities" used in engineering work. It is the first step in estimating production cost which in turn determines the price quoted, and is, of course, the crucial step in any contracting business. Printed forms are useful since they demand careful attention to the script to fill out. A set of such forms that I designed about ten years ago consists of five printed 8½" x 11" sheets, one for sets, one for locations, one for acting parts, one for scenes and a summary sheet. There are columns and spaces to be filled in or checked which include all possible specific technical requirements of each scene, each role, each set and each location and all production specifications and data for the summary sheet.

In making a script analysis the script is first read through carefully to get the general development of the story, the mood and pace. Then scene by scene, the technical information concerning each scene is entered on the scene sheets. Each role, each location and each set is similarly entered on the appropriate sheet in order of its appearance in the script.

As a brief example of what infor-

mation is recorded in this process, the scene sheets provide 18 horizontal lines for 18 scenes to the page and 17 vertical columns. In these columns the scene is marked as to whether it is a stock shot or an insert, its number, its location—exterior, interior or set by letter of set or location number, the optical effect—fade, wipe, dissolve or cut introducing it, its distance—long shot, medium, close-up, etc., a description of the action, the number in the cast in that scene, the sound required: Direct—meaning made simultaneously with the action; Voice-over—meaning recorded either before or after the shooting since the speaker does not appear in the action or is thinking to himself; PS — meaning either prescored or post-sync in which the sound is either recorded first, as in musical numbers, dancing, etc., and the action synchronized with the sound, or, the sound is recorded after the action is photographed and synchronized to the action; MU means a musical background is required and FX means sound effects are required. The next column records the time in seconds the scene will play, determined by the controlling element of the scene—action or sound—in conformity with the mood, pace and development of the story and in the last column the time is translated into feet. The other sheets record the appropriate information for sets, locations and roles. As each scene is studied the analyst "shoots it in his head" and any errors, inconsistencies or scenes that will not "play" are spotted if they are in the script.

The analyst must recognize difficulties as they appear and solve production problems in advance. He will automatically allow for extra shooting time when he finds scenes involving large casts, small children, difficult action or tense situations with rapid, emotional dialogue. Any scenes requiring special preparatory steps are noted and the steps described in the space provided on the summary sheet. When done carefully, the script analysis, in addition to supplying complete data on the material, labor and time requirements for the estimate, also provides technical information in a form easily transferred to the "production" script —a script arranged in shooting sequence not picture sequence and providing data for matching and editing. It also provides the information needed for detailed production scheduling by which the most economical use of talent, sets, locations, equipment and crews can be planned.

Cost Estimating

A printed cost estimating form is valuable since oversights are costly. The form may be designed to fit the facilities and policies of the particular producing company. One company, for instance, for which I designed an estimating form enters its production overhead on a man-hour basis. The total direct labor hours multiplied by the hourly production overhead rate provides the amount charged to that job. When this amount is added to the direct costs, 10% of this total is entered as selling and administrative expense. The total of direct costs, overhead, and "S & A" is multiplied by 5/3 to arrive at the selling or contract price.

In consulting work, direct cost estimates are made on a form consisting of three pages which summarize all costs in the various categories under the major divisions of (A) material (page 193), (B) direct labor (page 194), and (C) other costs (page 195). The individual items are computed from the script analysis on work sheets and attached to the form for reference. These forms were designed purposely to compile direct costs on the basis of a producer owning no facilities or equipment whatsoever and do not include overhead or selling and administrative expense. This form provides a satisfactory basis, since it includes all items of material and labor (which should be very nearly the same for all

union producers) plus the rental costs of all equipment and facilities necessary for production of the particular script involved, regardless of what facilities are owned or not owned by any particular producer.

In making an estimate, the quantities of material, labor and time provided by the script analysis are translated into dollars and cents. This step requires an extensive knowledge quite apart from that used in script analysis. The current pay scales, rules, customs and working habits of all union help and talent must be known plus the sources, prices, rentals and costs of all materials and equipment. The estimate must extend the actual shooting time required to allow for travel, preparation, finishing, advance transport of heavy equipment, providing power supply, weather delays, subsistence allowances for location crews and all of the numerous items that enter production costs. The financial expenses such as permits, rights, releases, royalties, copyrights and insurance—both regular "negative" insurance and on crews when engaged in hazardous work, must be included.

The estimator must have good judgment, in addition to his knowledge, since there are often two or more methods of accomplishing the same effect in film production. It may be a question, for instance, whether certain sequences can be done more economically on location or in studio; whether the transportation and subsistence costs are greater than the cost of building a set. Often interior locations are available but present such problems of lighting, acoustics or space for camera and cast movement that it is cheaper to duplicate the interior in a studio. Sometimes scenes require action inside planes, trains and automobiles that can't be done in actual vehicles and must be done with mock-ups in studio. There is very often the problem of deciding whether money will be saved by overtime work or extending the regular shooting schedule. The estimator must make many decisions carefully since there are always offsetting factors to be considered.

Beside the straight production problem decisions which may affect a particular producer's estimate, there are often other factors to cause variations in quotations. Sometimes locations are available to one producer and not to another. Or a script may be slanted toward a certain producer. I recall one script that was loaded with scenes requiring process screen. It had been written by a company that had recently invested heavily in rear projection equipment. There was no justification whatever, cinematically, for the scenes but another producer would have had to either ask for changes in the script or allow for considerable extra expense, since all of the background scenes necessary for the process screen shots had to be made in the home town of the company that wrote the script.

The estimate must be realistic—too large an allowance for contingencies is just as bad as too much dependence on luck. Some producers, of course, when faced with making a competitive price for a job cut the quotation and depend on creating "extras" to make a profit; and there are some who hedge by finding fault with the script as written, but report that with certain changes a picture can be made along the same general idea for X dollars. Since the changes are not specified this is a safe offer for any producer. Such practices are found in all contracting business and are not unique to film production. However, a capable estimator with a complete script analysis should be able to justify his judgment and his price, provided, of course, that the client can appreciate the difference between quality production and newsreels.

Contracts, Schedules, and Controls

Contracts in film production, whether for a script or a film, usually provide for a "down" payment of ¼ or ⅓ of the contract price upon signing and

further payments upon completion of specified steps in production. Since contract films are made to order and are of no value to anyone except the purchaser the partial payment before work begins is justified and customary. Special contract forms are often encountered in government work, which vary from department to department and often include a number of special requirements or regulations, which may or may not be strictly enforced in practice.

In content, a contract should specify what the producer is to provide and what the purchaser provides, if anything. This is done most easily on the exception basis, that is, the producer provides all materials and services necessary for complete production of the film except for certain items — which are then specified. Such items may be use of locations, products, personnel, drawings or properties, etc., of the client's. The general type, length, whether in black and white or a specified color system, the number of prints included, provision for copyright assignment, delivery or storage of the negative, possible sales taxes and delivery dates should be covered. Provision for changes from the approved script during production, if requested by the client, should be made, to be effected by "change orders" specifying the cost increase or decrease and signed by the client's representative. In many cases it is also wise to include provision for cancellation of the contract and settlement for work done in the event of conditions preventing its completion within a specified time. In contracts made with or through advertising agencies, agency commission should be specifically included or excluded.

Although film sponsors are prone to procrastinate and delay before signing a contract, after signing they become speed demons in many cases and say "This picture must be finished, you know, in time for our president's birthday next week!" or, "We have just changed the date of our annual sales meeting from October 15th to September 1st this year—so you will have to hustle this thing along so that our directors can see the finished film not later than August 1st, etc., etc., etc." Also, to maintain any degree of efficiency, the production department must make schedules. Detailed production scheduling is a complex job but an overall schedule in terms of "steps" can be made, at least tentatively, as soon as a production order is received.

A form for this purpose (page 196) consists of four pages, one for *script-writing* schedules and three for *production*—one for *preparation,* one for *shooting* and one for *finishing.* Each is divided into numbered steps or operations and space is provided for notes and entry of dates under "planned" and "performed" with sufficient space for revision of dates which may become necessary for many reasons. These steps are in the general sequence of production but it should be mentioned that not all steps are required in some pictures and while sequence has to be followed in certain production operations, others may proceed simultaneously. For example, sets may be designed, properties secured and casting completed on the same date—the work being done by different personnel during the same period.

All production, whether a script, film, a revision of a film, special shooting for "record" purposes or speculative work, is started only on a production order. Such orders are a form, filled in to show the specifications for the work by the sales or other originating department, and are routed first to the accounting department where they are entered in the Production Order register and given a number. This may be merely a consecutive number or may be coded to provide further information, but it is immediately positive identification of that job and will appear on all subsequent time sheets, requisitions, purchase orders, etc., since titles are subject to

change. After the accounting department heads up cost accrual sheets and a job folder with the job number, the production order is sent to the production department.

All material, rentals, purchases, services from other departments or outside services are requisitioned by the production department. Routing of requisitions and issuance of purchase orders depends on the organization of the company, but in all cases a copy of all requisitions and purchase orders should go directly to accounting for filing in the job cost folder as an incurred cost though not yet billed by the supplier.

Since labor is usually a large part of film costs, timekeeping and charging must be a fast and positive system. Since staff members may work on various jobs in one day, daily time sheets are useful for them while a different format with space for seven days is more desirable for crews. Another form, which includes a release, is used for talent.

System is often considered necessary only after organizations reach a certain size, which is an erroneous attitude and may easily prevent an organization from ever growing beyond its starting size. A realistic attitude toward system shows that the need for system increases directly as the complexity of the job and the costliness of mistakes increases, regardless of whether it is a one-man job or a group effort. Since film production is definitely a complex job and mistakes are costly, producers need system no matter what their size. Because sales and production personnel frequently resent system, claiming it hampers their genius, etc., it is often the accountant, either within the company or outside, who uses and knows the value of system, who must suggest, design and install system.

No single paper, not even this economy-sized one, can be a complete manual of motion picture production accounting. Consequently I have tried to cover those phases not found in other business and to show that, although both theatrical and commercial producers use the same techniques, the same equipment, the same unions, the same materials, etc., theatrical production is speculative but commercial production is a highly competitive contracting business. And, that while theatrical production costs bear little relation to its profits, commercial production costs directly affect its prices and profits.

As accountants you will, of course, realize that internal control is just as necessary in film production as it is in other business, and that proper accounting principles, applicable to contracting operations, also apply to commercial motion picture production. As a motion picture consultant, I can assure you that, although film production methods may be strange to you, there is nothing mysterious in it, as a business. The finished product, a motion picture, is often considered an intangible and its value depends on how well it serves the purpose for which it is designed, produced and used. However, all of its ingredients—facilities, materials and skilled labor—involved definite costs and are just as tangible as those of any other business.

COMMERCIAL MOTION PICTURE PRODUCTION ACCOUNTING

NOTE: The following captions and items are printed on a ruled sheet.

Prod. No. COST ESTIMATE

Title: Date.....

Client: SHEET "A"—MATERIAL

		Unit Price	Amount	Total	%
1. *Raw Stock*					
a. Picture negative	Ft. at $				
b. Sound negative	Ft. at $				
c. Magnetic track	Ft. at $				
d.	Ft. at $				
e.	Ft. at $				
2. *Laboratory*					
a. Develop pic. neg.	Ft. at $				
b. Work print	Ft. at $				
c. Develop snd. neg.	Ft. at $				
d. Track print	Ft. at $				
e. Fine grains	Ft. at $				
f. Dupe negative	Ft. at $				
g. Answer comp. prt.	Ft. at $				
h. Ans. red. print	Ft. at $				
i.	Ft. at $				
j.	Ft. at $				
3. *Library and Effects*					
a. Stock ftg. scratch	Ft. at $				
b. Stock ftg. F. G.	Ft. at $				
c. Fades	Ft. at $				
d. Wipes	Ft. at $				
e. Dissolves	Ft. at $				
f. Special effects	Ft. at $				
g. Stock music	Ft. at $				
h. Stock snd. effects	Ft. at $				
i.	Ft. at $				
j.	Ft. at $				
4. *Other Material*					
a. Sets					
b. Properties					
c. Costumes					
d. Titles					
e. Animation					
f. Models					
g. Special score					
h.					
i.					
j.					
			Total		
			Forward		

COMMERCIAL MOTION PICTURE PRODUCTION ACCOUNTING

Prod. No. COST ESTIMATE

Title: Date.....

Client: SHEET "B"—DIRECT LABOR

		Unit Price	Amount	Total	%
1.	Research	Man/days at $			
2.	Scriptwriting	Man/days at $			
3.	Management	Man/days at $			
4.	Direction	Man/days at $			
5.	Production Crews Studio & Location				
	a. Asst. Director	Man/days at $			
	b. Script Clerk	Man/days at $			
	c. 1st Cameraman	Man/days at $			
	d. 2nd Cameraman	Man/days at $			
	e. Still Man	Man/days at $			
	f. 1st Electrician	Man/days at $			
	g. 2nd Electrician	Man/days at $			
	h. 1st Prop. Man	Man/days at $			
	i. 2nd Prop. Man	Man/days at $			
	j. 1st Grip	Man/days at $			
	k. 2nd Grip	Man/days at $			
	l. .... Electricians	Man/days at $			
	m. .... Prop. Men	Man/days at $			
	n. .... Grips	Man/days at $			
	o. 1st Soundman	Man/days at $			
	p. 2nd Soundman	Man/days at $			
	q. .... Boom Men	Man/days at $			
	r. 1st Make-up	Man/days at $			
	s. 2nd Make-up	Man/days at $			
	t.	Man/days at $			
	u.	Man/days at $			
	v.	Man/days at $			
6.	Art—Design	Man/days at $			
7.	Editing and C & M Neg.	Man/days at $			
8.	Narrators				
9.	Cast				
10.	Special Effects-Prod.				
11.	Set Construction				
12.	Musicians and Sound Effects Men.....				
13.	.....				
14.	.....				
			Total		
			Forward		

COMMERCIAL MOTION PICTURE PRODUCTION ACCOUNTING

Prod. No. COST ESTIMATE

Title: Date.....

Client: SHEET "C"—OTHER COSTS

		Unit Price	Amount	Total	%
1. *Rental Items*					
a. Sound stage	Days at $				
b. Location rental	Days at $				
c. Recording studio	Hrs. at $				
d. Screening room	Hrs. at $				
e.	Hrs. at $				
f. Camera equipment	Days at $				
g. Lighting equipment ...	Days at $				
h. Sound equipment	Days at $				
i. Editing equipment	Days at $				
j.	Days at $				
k.	Days at $				
l.	Days at $				
2. *Production Supplies*					
a. Electric power	$				
b. Batteries	$				
c. Lamps and carbons ...	$				
d.	$				
e.	$				
3. *Travel and Transport*					
a. Railroad and plane fares	$				
b. Station wagons—autos —cabs	$				
c. Trucking	$				
d. Express and freight ..	$				
e. Communications	$				
4. *Subsistence*					
a. Location subsistence ..	$				
b. Local crew meals	$				
c. Entertainment	$				
d. Misc. Location expense	$				
5. *Financial Expense*					
a. Insurance	$				
b. Royalties	$				
c. Copyrights	$				
d. Rights and releases ...	$				
e.	$				

Total .....

Mark-up factor .....

Contract price .....

"A"-Scriptwriting Schedule

1. Production order received from front office
2. Personnel assigned
3. Outline completed
4. Outline submitted to front office
5. Outline approved and returned
6. Script completed
7. Storyboard completed
8. Script and storyboard submitted to front office
9. Script and storyboard returned for revision
10. Revision submitted to front office
11. Script and storyboard completed for client approval
12. Script and storyboard returned for revision
13. Revision of script and storyboard submitted for client approval
14. Script and storyboard approved by client
15. Special item
16. Billing per contract

"B"-Preparation Schedule

17. P. O. and script received from front office
18. Script analysis completed
19. Art and animation estimate completed
20. Production estimate completed
21. Production cost estimate submitted to front office
22. Production budget received from front office
23. Personnel assigned
24. Script broken down for shooting
25. Production scheduled
26. Animation scheduled
27. Stock and equipment scheduled
28. Crew booked and cleared
29. Conference, director and staff
30. Locations selected and requisitioned
31. Stages selected and requisitioned
32. Special steps or effects planned and scheduled
33. Transportation and accommodations arranged
34. Sets designed
35. Properties secured
36. Casting completed
37. Costumes secured
38. Special item
39. Insurance estimated and requisitioned

"C"-Shooting Schedule

40. Location shooting started
41. Location shooting completed
42. Location rushes screened
43. Studio shooting started
44. Special steps or effects completed
45. Studio shooting completed
46. Studio rushes screened
47. Animation shooting started
48. Animation shooting completed
49. Animation rushes screened
50. Insert shooting started
51. Insert shooting completed
52. Insert rushes screened
53. Retakes completed
54. Library footage selected and secured
55. Work print rough cut and synchronized
56. Approval screening
57. Photography completion billing
58. Title copy submitted to front office
59. Titles approved and ordered
60. Titles completed and cut in picture
61. Special item
62. Narrator selected and booked
63. Music selected or score completed
64. Sound effects selected or booked
65. Voices recorded
66. Music recorded
67. Sound effects recorded
68. Recording retakes
69. Special item

"D"-Finishing Schedule

70. Final cut editing completed
71. Approval screening for front office
72. Editorial revision screening
73. 2nd Editorial revision screening
74. Editing completion billing
75. Negative cutting and matching
76. Fine grains ordered
77. Fine grains received, optical effects ordered
78. Optical dupe negative cut into negative
79. Re-recording all tracks
80. Combined track synched to picture
81. Composite answer print ordered
82. Application for copyright filed
83. Answer print screening for front office
84. Edited film content analysis completed
85. Answer print screening for client
86. Contract prints ordered
87. House print ordered
88. Director's notes and summary filed
89. Contract prints delivered
90. Final billing
91. Indexing of new library material
92. Disposal of cuts, out-takes, etc.
93. Negative disposition arranged
94. Special items

The Necessity for the Experience Requirement for Certified Public Accountants

By HENRY P. HILL, C.P.A.

After a brief consideration of the deficiencies of accounting beginners and the resultant implications for college training in accountancy, the author concludes that actual experience in public practice is an essential element of the young accountant's professional preparation. He believes that such experience will also improve the candidate's chances of success in passing the CPA examination; also, that related non public experience is not a satisfactory equivalent therefor.

THE accounting profession from time to time finds itself the object of pressure to ease or eliminate the experience prerequisite for the certified public accountant's certificate. This pressure generally comes from applicants who feel they have parallel experience of equal value to the type of experience now required or from state regulatory agencies faced with the necessity of judging the adequacy of experience in borderline cases. Less frequently this pressure is exerted by outsiders who view the present requirements as monopolistic, and as having been established to protect the interests of present practitioners to the detriment of the public good. The real purpose of the experience requirement is often lost sight of in the arguments presented.

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Mr. Hill is a graduate of the Wharton School of Finance and Commerce of the University of Pennsylvania. During World War II he saw extensive service with the U. S. Navy, afloat and ashore.

Some Basic Deficiencies of Beginners in Accountancy

Almost thirty years ago Professor J. Hugh Jackson wrote an article for the *Journal of Accountancy* in which he listed eleven deficiencies complained of by professional accountants in their new assistants. One of the remarkable things about this article is that it is referred to in the accounting literature from time to time even to this day. The deficiencies listed by Professor Jackson may be summarized as follows:

1. Inability to use the English language effectively.
2. Lack of acquaintance with actual methods in use in the accounting departments of business concerns.
3. Lack of conception or real knowledge of the scope of work at present undertaken by the accounting profession.
4. Failure to realize that the verification or analysis of figures is not in itself an end, but is only a means of guiding the progress of a business.
5. Have never been taught to think accurately and correctly.
6. Lack of knowledge of the principles of business arithmetic.
7. Lack of understanding of business terms.
8. No specific knowledge of securities and no knowledge whatever of the work incidental to the inspection of securities.
9. Little conception of an audit program and little knowledge of the importance of the method of preparing working papers.

10. Lacking in speed and accuracy in handling figures, even to the extent of simple multiplication and addition.
11. Lacking in thoroughness and in power of concentration and have practically no ability to do routine work with intelligence and speed.

The fact that Professor Jackson's criticisms are still referred to from time to time in accounting literature, seems to indicate that certain of them cannot be corrected by formal education. It is relatively simple to pick out those items which fall within such a group. For example, the criticisms relating to lack of acquaintance with actual business methods in use today, the lack of real knowledge of the scope of work at present undertaken by the accounting profession, the lack of understanding of business terms, the absence of specific knowledge of securities and the work incidental to their inspection, the inadequate concept of an audit program and the absence of knowledge of the importance and the method of preparing working papers, the deficiencies in speed and accuracy in handling figures and the lack of thoroughness and power of concentration, reflect lack of experience rather than lack of education.

The relationship of professional accountants with outsiders is such that shortcomings of this nature are viewed critically by the public and by the profession. In the corporate field, for example, a beginner has allowances made for him by his associates, whereas men engaged in professional work are usually assumed to be experts. A corporation engaging a recent college graduate, for example, will probably not be surprised if its new employee cannot carry out simple arithmetical computations with speed and accuracy. Such skills are acquired by practice rather than formal education. On the other hand, a certified public accountant is assumed by the outside world to be proficient in these matters beyond the skill of the average non-CPA.

Implications for College Training in Accountancy

This is not necessarily a criticism of the college training currently being given accounting students. In the short time at its disposal the college should not confine its aims toward equipping students with all the technical requirements to handle their jobs during their early years in the profession, but should endeavor to expedite their rise to positions of greater responsibility. This calls for broad training in accounting theory and business philosophy at the expense of narrow, overspecialized training in accounting techniques. Educators recognize that the certified public accountant should be a high-level professional man and an influential member of his community as well as a skilled practitioner. Many of them also recognize the difficulty of producing both an educated and a professional man in a four-year college course. Taking cognizance of this dilemma of the accounting instructors, can we say that they should devote more time to teaching the techniques of a profession at the expense of a broader education? I think not, and yet our clients need and expect proficiency in the techniques as well. They will not employ us long if we are slow and bumbling, inaccurate or careless with the facts, uncertain or unrecognizing of their problems and timid in suggesting solutions.

The CPA's certificate is the ultimate in public recognition of accounting skill. Beyond it there are no more formal steps to be taken. Every man certified must, therefore, measure up to the standards forced on the profession by its clients. The phrase "inexperienced certified public accountant" is a contradiction in itself. The constant pressure to ease the CPA requirements is evidence of the intense desire of many to obtain this symbol of proficiency and shows the position attained by our profession. This position arises from the recognition of our standing in the business world.

Experience, the Keystone of the Training Arch

A discussion of this kind invites comparisons with other professions. A profession that readily springs to mind is the medical profession. We are all familiar with the program of internship under which the medical student, after he has been graduated, is required to spend a year or more observing the work of experienced members of the profession and practicing under observation what he has learned during the course of his formal studies. This program has been adopted because neither the profession nor the public would want a doctor to perform, say, an appendectomy purely on the strength of his having read how to do it in a book.

Similar standards should apply to the accounting profession. If the first criterion for admission to the accounting profession is to be whether the standards are sufficiently high for the protection of the public, every man entitled to place the words "Certified Public Accountant" after his name should have sufficient experience to enable him to cope with the problems of the average client he is likely to encounter. The classroom-taught man tends to think that because he has understood a thing he is able to carry it out in practice. Only the recurring experiences of the commercial world can produce that facility for handling the day-to-day problems which will be encountered. If you support the postulate that it would not be in the public interest to allow the doctor to practice medicine until he had actually diagnosed, prescribed and administered to real, live patients under the close supervision of experienced physicians, then you should support the idea that the newest and most recently made certified public accountant must have had some experience in handling clients' books of account, conducting examinations of clients' financial statements and preparing clients' tax returns.

The question can be raised, of course, whether these are criticisms of the present CPA examinations. The efforts of the various boards of examiners continue to be directed toward making the examinations more practical. It is doubtful whether they can make them a substitute for experience, however.

Experience Improves Chances for Passing the C.P.A. Examination

In his evaluation of the education and experience of 1,200 candidates taking the November, 1946, examination, Norman Lee Burton, educational director of the American Institute of Accountants, wrote:

> "The number of successful candidates without experience (92 out of 1,200) is very small. That there should be any is a matter of some significance."

The April, 1952, study by Harold Howarth of the educational and experience requirements of 9,829 candidates sitting for the examinations of May and November 1949, May 1950, and May 1951, concludes that where educational backgrounds are the same the candidates with more than two years' experience are more successful. Doesn't this mean that by and large we do not delay the certification of our candidates by the experience requirements; that, instead, we really endow them with a facility for passing the CPA examination? We are also faced with the fact that if we change our examination viewpoint to stress, where possible, the techniques of day-to-day practice, those educators who desire can undo the effect of our efforts by making changes in the slant of their accounting courses to the detriment of the training in theory and business philosophy mentioned earlier. Many, of course, will not, maintaining that the college program should not be a cram course for an examination.

If our educators recognize that they are unable to give accounting students a sufficient proficiency in the technique

of accounting practice and if our examinations are not organized to measure this factor, it falls upon the accounting profession to see that its prospective members acquire the necessary techniques and skills before they become full-fledged independent practitioners. The only practical method of attaining such a goal is the experience requirements making it mandatory for all candidates to undergo a period of training under a practicing CPA.

Related Experience Is Not a Satisfactory Equivalent

What then, about the value of parallel experience? In my opinion practical experience should be obtained in the work of certified public accountancy. Experience in governmental accounting, private accounting, or in teaching accountancy cannot be accepted as satisfactory substitutes because they either do not supply practical experience in varied situations or they do not foster the independent impartial approach of the CPA. To return to Professor Jackson's criticisms of the beginners, no amount of governmental experience will rectify a lack of acquaintance with actual methods in use of the accounting departments of business concerns today, nor would any governmental experience endow a candidate with an adequate conception of the scope of work at present undertaken by the accounting profession. The nearest approach to professional accounting in governmental service is probably in the work of the internal revenue examiners. But even this work has the twofold inadequacies of narrow scope and lack of impartial approach.

Experience in the accounting department of one business would lead to proficiency in the methods of the one concern in question, but would not lead to a knowledge of methods actually in use in the accounting departments of other business concerns nor would it enhance the beginner's knowledge of the scope of work at present undertaken by the accounting profession in general. Similar criticisms may be made of teaching experience.

It seems to me we should emphasize the meaning of the term certified public accountant. The certificate is a license to practice *public* accountancy. *Public* accountancy is a profession unique among the professions. It is founded upon the concept of independent and impartial approach to the facts. It requires its members to be aware of much confidential information without revealing it to unauthorized persons. Its modes of practice are embodied in the profession's code of ethics. The acquisition of its viewpoints is largely achieved by practice. It is not something that can be acquired simply by being read about. Substitute experience in government or in private accounting for experience in professional public accounting and you are substituting experience as an advocate in behalf of public or private interests for training in professional impartiality. Eliminate the experience requirement altogether and you are reducing the certified public accountancy certificate to another form of academic degree. Education and experience are not interchangeable; they are supplemental. It takes both to make a competent, professional Certified Public Accountant.

New York State Tax Forum

Conducted by BENJAMIN HARROW, C.P.A.

Gain From Sale or Exchange of Residence

The 1953 Legislature added Section 354-a to the Income Tax Law relating to non-recognition of gains resulting from a sale of a residence. This change follows generally the 1952 amendment of Section 112 (n) of the Internal Revenue Code. In the November 20, 1953, revision to the Regulations the State Tax Commission added Article 489, explaining its understanding of how this new provision is to operate. The regulation in the main follows closely Section 39.112 (n)(1) of the federal regulation, with some differences that should be noted.

Beginning with January 1, 1952, no gain will be recognized from the sale of property used as a principal residence if the taxpayer purchases property and uses it as a principal residence within a period beginning six months prior to the date of sale and ending six months after such sale. If a new residence is being constructed the new provision applies, if the new residence is so used within a period of one year after the date of sale of the old residence. This differs from the federal rule, which would make the gain nontaxable if the acquisition of the new residence were made within a period of one year prior to the sale and one year after the sale. The federal rule is more liberal. Non-recognition of the gain is mandatory under both laws. Under the New York law a resulting loss is recognized, whereas it would not be recognized under federal law.

Under both laws property used as a principal residence may be a house boat, a trailer, or stock in a cooperative apartment corporation, and it would not include personal property. If property is only partly used as a residence, a two-family house for example, an allocation must be made to determine the portion of the gain which is not to be taxed.

Both laws consider an exchange of property as a sale; also, destruction, seizure or condemnation. Mortgages, commissions and other selling expenses are not to be deducted in determining the selling price. Likewise, the cost of the new residence includes all mortgages. Commissions are included in determining the cost.

If husband or wife both wish to obtain the benefits of this section they may do so by filing a consent to have the basis of the interest of either of them in the new residence reduced by the unrecognized gain. That means that the new law may apply if only one of the taxpayers owns the old residence and both own the new residence or the

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Mr. Harrow has been a member of the American Institute of Accountants since 1922 and is a member of the New York Bar. He is a past Vice-President of the Society and is now serving on the Society's Committees on Awards and Publications. He is a past Chairman of its Committee on State Taxation. He is also a member of the Institute's Committee on Federal Taxation.

Mr. Harrow is engaged in practice as a certified public accountant and attorney in his own office in New York City.

reverse. Both spouses must sign the consent and an original copy must be filed with each return if separate returns are filed.

The essence of the rule that a gain on the sale of a residence is not recognized is that the taxpayer merely receives a return of his capital, his cost. The new residence gets a basis represented by the adjusted basis of the old residence reduced by the unrecognized gain on the sale of the old residence.

The statutory period for assessing a deficiency attributable to a gain on the sale of a residence will not expire prior to the expiration of three years from the date the Tax Commission is notified of the cost of purchasing the new residence, or three years from the date the Commission is notified that the taxpayer does not intend to purchase a new residence within the period of six months. The notification shall be made directly to the Commission or in the return for the taxable year of the event determining the taxability or non-taxability of the gain.

Change in Accounting Period

We recently[1] discussed federal Regulation 39.46.1 permitting a taxpayer to change his accounting period without the prior consent of the Commissioner. We pointed out that the new regulation would affect the rule under the state law. Article 528 has now been revised to require a taxpayer to change his accounting period for State tax purposes if it is changed for federal income tax purposes. If the change was made with the consent of the Commissioner, the taxpayer must file with the first State return a copy of the consent of the Commissioner. If the change is being made without the consent of the Commissioner, a statement to that effect is required with the filing of the first return based upon the changed period.

If the taxpayer is not subject to federal income tax, he is required to notify the Tax Commission of the change and the reasons. The notice must be given 30 days before the due date of the return based upon the existing taxable year and 30 days before the close of the proposed taxable year. The Tax Commission must approve the change.

Greetings and Welcome to Commissioner Frederic R. Blair

Governor Dewey has announced the appointment of Frederic R. Blair to the State Tax Commission for the term ending December 31, 1954. We welcome the addition to the Tax Commission of a man who comes to it with valuable tax experience gained in the office of one of the large law firms. Commissioner Blair is a graduate of Yale University and studied law at the University of Virginia Law School. In addition to his other qualifications, he brings with him the enthusiasm that accompanies a man of 36 interested in the field of taxation and public service.

Entire Net Income—Treatment of Charitable Contributions

Entire net income is one basis for the franchise tax on business corporations. Entire net income is presumably net income as determined in computing the federal income tax, with certain specific inclusions and exclusions. A net operating loss of other years is deductible in arriving at net income for federal income tax purposes, but not in arriving at entire net income for franchise tax purposes. An adjustment is thus required to net income in arriving at entire net income.

The deduction for charitable contributions is limited to 5% of net income before contributions in determining net income for federal tax purposes. An operating let loss deduction will reduce net income and thus may reduce the allowable deduction for charitable contributions. Is the charitable deduction for franchise tax pur-

[1] State Tax Forum—December, 1953, page 786.

poses affected by the federal limitation? A revision of Article 311 of the Regulations[2] added Item (14) to the list of deductions from federal net income and provides that "charitable contributions made but not deducted in computing Federal net income solely because of the reduction of such income by net operating losses of other years which are added to federal net income in computing 'entire net income'. . . are deductible."

Rented Real Property in the Allocation Formula

The allocation formula is the device used to determine what portion of entire net income of a corporation is subject to franchise tax in New York. The first step in applying the allocation formula is to determine whether the corporation is entitled to any allocation at all. A regular place of business maintained by the corporation without the state entitles a corporation to a partial allocation, only under the property factor. A permanent and continuous place of business maintained by the corporation without the state entitles the corporation to a full allocation under all three factors, property, payroll and receipts.

The property factor is a fraction showing the ratio of real and tangible personal property within New York to the average fair market value of all such property within and without New York. Real property rented is included in the property factor, and in fact must be included. Such property is considered to have a fair market value, for purposes of inclusion in the formula, of eight times the gross rent. The general effect of the inclusion of rented property in the property factor is to consider a larger portion of entire net income as taxable in New York if the rented property is located in New York, and a smaller portion if the rented property is located outside New York. The Tax Commission has been confronted with the problem of the meaning of gross rents where a portion of the rented premises is subleased. Is the rental payment adjusted by the income before multiplying the gross rents by eight to determine the fair market value of the rented property?

A December 16, 1953 amendment to Article 412 (1) of the Regulations provides that the portion of any rental payment applicable to property subleased is excluded in computing gross rent.

Franchise Tax—Transportation Corporations

A corporation taxable as a transportation company under Section 183 of Article 9 decides to liquidate. It thereupon ceases doing business and proceeds to dispose of its assets and to liquidate its liabilities. In the course of its liquidation it makes a distribution to the stockholders and proceeds with its further liquidation. Before it has been dissolved another franchise tax return is due. What effect does the distribution in liquidation have upon the tax?

This franchise tax is one on the privilege of doing business in a corporate capacity in the state in the future. All corporations in existence on December 31 of any year must file a report not later than March 1 of the succeeding year. The tax is imposed upon the value of the capital stock of the corporation apportioned to New York. The rate of tax is generally one mill on the net value of the capital stock, such value determined by the difference between the assets and liabilities averaged for the preceding year. However, if dividends of 6% or more have been paid during that preceding year, the rate is ¼ of a mill for each per cent of dividends applied to the par value of the stock or upon the amount paid in for no par stock. That means that the tax is automatically 2½% of the amount of the dividend.

Under the facts stated above the Tax Commission will probably treat the dis-

[2] December 16, 1953.

tribution as one in partial liquidation and, to the extent that it is paid out of surplus, with the capital left intact, it will regard the distribution is a taxable dividend. In the event of a final distribution in liquidation followed by a formal dissolution, there will be no corporation left to tax when the tax return for the following year is due. The Tax Commission does not consider a partial distribution as part of a final distribution unless all the distributions have been made before December 31 and the corporation has been dissolved by that date.

The corporation may argue that if it is not "principally" engaged in the transportation business it is not subject to tax under Section 183 of Article 9. That would be the case from the moment it votes to liquidate and ceases doing business as a transportation company. The change in the nature of its activities results in a change of classification. In the case of transportation companies the law is not clear as to when the change of classification occurs. However if the law with respect to real estate companies is a criterion the change should immediately subject the transportation company to tax as a business corporation. In any event the change would be applicable on January 1 of the following year.

Income Tax—Period of Limitations

Section 373 of Article 16 requires the Tax Commission to examine and revise a tax return within three years after the return was made. That has been construed to mean the last day prescribed for the filing of the return even though the return was filed before the last day. Where an extension of time for filing has been granted it means the last day of such extended period.

If the taxpayer himself wishes to revise his return he must file a formal application for a revision of the tax within two years from the time of the filing of the return. So far as the taxpayer is concerned he must file such a claim within two years from the actual filing date of the return as shown by the records of the Income Tax Bureau. If the Tax Commission has recomputed the tax within the three-year period, the taxpayer may file an application for revision or refund within one year from the time of the mailing of the notice of the Tax Commission.

Some taxpayers feel that this disparity in the time limitation is inequitable to the taxpayer. The Tax Commission does not feel sympathetic to the taxpayer on the ground that its administrative problem is such that it should be given more time to foreclose its rights than a taxpayer who is more familiar with his own tax problems than the Tax Commission.

One of our members calls our attention to a case where the Tax Commission audited an estate tax return and disallowed a deduction which it claimed should have been taken by a beneficiary. Since the audit of the estate was made two and a half years after the beneficiary had filed his return, the beneficiary could not file a claim for revision of his return because of the two year period of limitations. At least in the case of related returns it would seem that the taxpayer should be put on a par with the state so far as time limitations are concerned for revising returns.

What's Brewing in the Legislature?

It is interesting to know what bills are being considered by the Assembly and the Senate for amending the tax laws. Several Assembly bills have been introduced to eliminate both the floor and the ceiling in the deduction for medical expense. Since a deduction for personal expenditures is generally not favored, it is unlikely that this bill will pass. Certainly the Tax Commission is unlikely to approve it.

Another bill would increase the floor from 5% to 10% of aggregate net income of husband and wife but would

increase the ceiling from $1,500. to $2,000. A single individual would still be limited to a maximum deduction of $750. although as a head of a family the limitation would be $2,000.

Another bill seeks to exclude from income dividends or interest in money or kind up to a total amount of $100. per person in any taxable year. Congress is presently considering some kind of relief for taxpayers from so called double taxation of dividends. Presently being considered is a credit against the tax up to $50. plus an exclusion from gross income of a percentage of the dividend, with increased credits and exclusions in subsequent years. The State will probably introduce some similar form of relief but most likely will not do so until it sees what the federal pattern of relief will be.

One bill would allow the dependency exemption of $400. for any dependent who receives more than one-half his support from a taxpayer. The present law limits the exemption to a dependent under 18 years of age, or to a dependent incapable of self support because mentally or physically defective, or to a dependent over 18 years of age and in full time attendance at an approved school or college.

An Assembly bill has been introduced excluding from gross income pensions paid by the U. S. Government for past services to veterans or widows of veterans. At the present time such pensions would be taxable unless they were received "under any law for the benefit or relief of injured or disabled members of the military or naval forces of the United States." (Article 40c(3)).

In 1949, Section 210 of the franchise tax law was amended to permit the inclusion in the property factor of the allocation formula of rented property. A bill just introduced will exclude from the property factor rented property used for executive offices. The sponsor of this bill probably feels that since salaries of executives are excluded from the payroll factor, the rental of executive offices should be similarly excluded from the property factor. The bill would help those corporations who maintain executive offices in New York. Under the present formula the property factor is weighted in favor of New York. Under the amendment the property ratio would apportion less of the income to New York.

Accounting at the S. E. C.

Conducted by Louis H. Rappaport, C.P.A.

Revision of Form 10-K

Corporations whose securities are listed for trading on a national securities exchange are required to file an annual report with the SEC and the exchange. In addition, certain issuers of publicly offered securities must file a similar report with the SEC even though the company's securities are not listed on an exchange. In most cases this annual report is filed on SEC Form 10-K; it is not to be confused with the usual annual report of a corporation to its stockholders.

The SEC recently announced a comprehensive revision in Form 10-K with a view to eliminating the necessity for duplicating similar information which is contained in different reports. For example, much of the information which is presently contained in a proxy statement was also required to be included in the old Form 10-K. The new form provides that where a proxy statement involving the election of directors is filed with the SEC, then items 4 to 9, inclusive, of the new form shall not be restated or answered by any company. Thus, over half of the items in the narrative section of Form 10-K may now be omitted by companies filing proxy statements with the SEC since the same information is contained in the proxy statements. These simplified reporting requirements, insofar as they relate to the narrative section of the annual report, should result in savings in the burden and expense of complying with the Commission's reporting requirements and will likewise result in economies in the examination of such reports and processing by the Commission's staff.

Louis H. Rappaport, C.P.A., is a partner in the firm of Lybrand, Ross Bros. & Montgomery, C.P.A.'s.

The Commission's release dealing with the revision in Form 10-K also contains the following paragraph:

> The new forms also represent a step in the Commission's endeavor to encourage the publication of reasonably complete and detailed annual reports to stockholders. All reporting companies will be required to furnish the Commission, as supplemental information, with copies of their annual stockholder reports. The Commission intends to keep these in one file with proxy statements and other reports officially filed with it so that any interested investor can easily examine any available information about his company. At the same time, the reporting forms encourage the use of stockholder reports to satisfy the Commission's reporting requirements, particularly as to financial statements, when they contain the necessary information. It is hoped that this will lead an increasing number of companies to include in their stockholder reports balance sheets and profit and loss statements which are sufficiently full and detailed to meet the Commission's requirements. It is the Commission's experience that more and more stockholder reports now include this information.

We should like to point out that it has always been possible to file the stockholder report in satisfaction of the financial requirements of Form 10-K provided the stockholder report complied with the Commission's requirements. In the great majority of cases the financial statements in stockholder reports do not comply with Commission requirements for two reasons:

1) Stockholder reports do not as a rule contain the supporting schedules called for by SEC Regulation S-X;

2) Most stockholder reports omit certain required footnotes to finan-

cial statements (called "compliance" notes) dealing with such matters, for example, as depreciation policy and provisions of pension plans.

Moreover, the breakdown of fixed assets required in a balance sheet for SEC filing is frequently not found in a stockholder report.

The Commission's purpose in striving to reduce the filing burden is commendable and we should like to encourage any move in that direction. As far as the financial section of a Form 10-K report is concerned, if the accountant wishes to use the stockholder report as a basis, we think the accountant has two choices:

1) He can prepare the financial statements in the stockholder report in such form and including such notes as will comply with Regulation S-X. He can then furnish supporting schedules and a separate certificate covering such schedules. The certificate in the stockholder report and the certificate covering the supporting schedules should be manually signed;

2) The accountant can file the usual stockholder report as in (1) above even though it does not comply with Regulation S-X. These financial statements would then be supplemented by "compliance" notes and whatever other information and supporting schedules are required in Regulation S-X. The accountant would then be required to certify the supplemental notes and schedules and manually sign his certificate.

The first suggestion above does not appeal to us because we are reluctant to burden the stockholder report with footnotes merely because they are required in a SEC filing. The second suggestion also does not appeal to us because it results in a cumbersome, unworkmanlike presentation of the financial section of the report.

The instructions as to financial statements in the old form contained a rather unusual provision which was applicable to cases where the registrant represented 85% or more of the consolidation both from the viewpoint of assets and gross revenues. Where this situation prevailed, the registrant was given the option of filing either unconsolidated or consolidated statements. In the new form this option no longer exists. The instructions now require consolidated financial statements and, in certain cases, unconsolidated financial statements of the registrant.

One other provision in the instructions for financial statements deserves notice, although it is not new. Individual (unconsolidated) financial statements of the registrant may be omitted if consolidated statements are filed and the conditions specified in either of the following paragraphs are met:

(i) The registrant is primarily an operating company and all subsidiaries included in the consolidated financial statements filed are totally-held subsidiaries; or

(ii) The registrant's total assets, exclusive of investments in and advances to the consolidated subsidiaries, constitute 85% or more of the total assets shown by the consolidated balance sheet filed and the registrant's total gross revenues for the period for which its profit and loss statement would be filed, exclusive of interest and dividends received from the consolidated subsidiaries, constitute 85% or more of the total gross revenue shown by the consolidated profit and loss statement filed.

In (i) above, the term "totally-held subsidiaries" appears. This term is not synonymous with "wholly-owned subsidiary" as those words are ordinarily used. A "totally-held subsidiary" is defined in Regulation S-X as:

. . . a subsidiary (a) substantially all of whose outstanding securities are owned by its parent and/or the parent's other totally-held subsidiaries, and (b) which is not indebted to any person other than its parent and/or the parent's other totally-held

> subsidiaries in an amount which is material in relation to the particular subsidiary, excepting indebtedness incurred in the ordinary course of business which is not overdue and which matures within one year from the date of its creation, whether evidenced by securities or not.

From the definition, it will be seen that if the subsidiary has any substantial amount of debt outstanding in the hands of the public, it does not qualify as a totally-held subsidiary. Thus, if a subsidiary, all of whose voting stock is owned by the parent company, has a plant on which there is a mortgage held by a bank, the subsidiary is not totally-held.

Consistent with this understanding, the SEC has now added a definition of "wholly-owned subsidiary" to its regulations. The definition follows:

> The term "wholly-owned subsidiary" means a subsidiary substantially all of whose outstanding voting securities are owned by its parent and/or the parent's other wholly-owned subsidiaries.

The other changes in the present revision of Form 10-K are not of general interest to accountants.

AN ADIRONDACK VIEW

Bill White writes a column in the New York Herald Tribune, under the heading "Just About Everything". It is also syndicated; many of you may read it. One day we bought three papers and it was in all three—but they didn't fool us, we only read it once.

We have been asked about Bill. No, it is not a pen name of a certain CPA. Bill also loves the Adirondacks and his column has a lot of Adirondackana in it. He is a smooth writer, so says a Saturday Evening Post editor, smoother than any of us CPA's—in our opinion (short form).

When you come to the Saranac Conference and drive into Saranac Lake via Lake Clear, near Durgan's Grill, there, on the right, is a sign "Camp Intermission". Here, on Lake Colby, lives Bill White and family. He free lances—and shaves when the pressure gets too great. Like some others, he got tired of the big city, its canyons, and its smize, and graduated to the little city in the Adirondacks.

Bill wrote the article in the Saturday Evening Post about Saranac Lake and the one about the North Pole. We don't audit his local stories, but Sugar Bush is a real place—3 houses (at least) and twenty years ago it had a post office. Well, one does not have to be an Adirondack guide to tell whimsical—and tall stories.

LEONARD HOUGHTON, C.P.A.
"Adirondack Chapter"

Office and Staff Management

A forum for the exchange of views and information on all aspects of the administration of an accounting practice.

Conducted by MAX BLOCK, C.P.A.

Self-Insured Disability Plans—S.O.S.

Those of our clients who carry their own employees' non-occupational disability insurance under the New York law are facing serious payroll accounting and tax problems. This condition arises from the fact that benefits are deemed by the Treasury to be taxable income except where the employee pays all or part of the plan cost. As a consequence such employers are required to withhold income tax on disability payments to the extent that they are taxable. This creates a bookkeeping problem which even the Commissioner recognizes.

The Treasury is soliciting suggestions on practical methods for determining employees contributions, and making allowance for recoveries received by employees. Accountants can render a service to their clients and to the Treasury by applying their system and tax ingenuity to this problem. Send your ideas to the Commissioner of Internal Revenue, Washington 25, D. C., Attention: T:R:I.

Treasury Approves "Centsless" Accounting

Revenue Ruling 54-4 indicates that penny elimination accounting, a method used by large companies mainly, is acceptable for income tax purposes if maintained with reasonable consistency.

MAX BLOCK, C.P.A. (N. Y., Pa). is a former chairman of the Committee on Administration of Accountants' Practice of the New York State Society of Certified Public Accountants. He is a lecturer at The City College of New York in the graduate course on Accounting Practice. Mr. Block is a member of the firm of Anchin, Block & Anchin.

Reproductions of N. Y. Realty Franchise Tax Returns

The N. Y. State Tax Commission has approved, on a trial basis, the filing of mechanically reproduced returns on Form 42CT. The *type of paper, color,* and *quality of the reproduction* will be important considerations in influencing the Commission to make the privilege permanent.

Utilization of State Society Committees

The New York State Society of Certified Public Accountants has a number of industry committees whose purpose, amongst others, is the furnishing of accounting data regarding their particular industries to members. Several committee chairmen have indicated their surprise at the fact that, whereas they know that there is a great need for technical information, the number of inquiries from members is very small.

Society members should not overlook this unique opportunity to obtain, without charge, opinions and advice on difficult problems from men who are selected because of their outstanding positions in their fields. Address inquiries to the Society office.

Committees now functioning are the following:

Air Transport and Airport
Bank and Savings Institutions
Clothing Manufacturing
Contractors
Dairy Industry

Governmental Accounting
Graphic Arts and Allied Industries
Hotel, Club and Restaurant
Institutional Accounting
Insurance Companies and Agencies
Land Transport
Petroleum Industry
Public Utilities
Real Estate
Stock Brokerage
Textile Accounting

Other committees deal with special problems such as federal, state and local taxes; cost accounting and inventory methods; budgets; fiduciary accounting; and accountant's office administration.

Credit Executives' and Accountants' Relations

The proceedings of the April, 1953, conference of Credit Executives and Certified Public Accountants are being reported in this column in installments. Here is the third installment of questions and answers:

Question: Where your client has given permission for you to disclose whatever the bank might require in the way of running information, are you justified in asking the bank to keep that confidential?

Answer: Of course you are. If your client has given you that direction and that direction only, that is exactly what you must do.

Question: Sometimes during the course of the accountant's audit he makes certain recommendations to his client, such as maintaining perpetual inventory records. Years may go by—one, two or three years, say—and the client does not carry out those recommendations. What should the accountant do in an instance of that kind? What are his obligations?

Answer: It would seem to me that it would all depend on the nature of the recommendations and their importance to the business and to the client. If the recommendation is that certain changes be made in the system or that perpetual inventory records be kept, and the client does not do it, either because he does not want to pay for the expense or other reasons of his own, and it does not affect the basic fabric of the business, then that is the client's headache, I would say. He is just running a little less efficiently than he should.

On the other hand, if the accountant makes recommendations to his client which go to the very heart of the business—for example, let us consider the business Mr. Schoenfein was discussing before: It is on the down trend and getting into dangerous waters; the accountant makes certain specific recommendations which he knows the client can follow if he wants to, but the client does not accept the recommendations—then I think the accountant would think twice and take one of several courses. He would not sit back and do nothing. He might, if the substance of the recommendation is sufficiently important, relinquish the engagement; and he would not only be justified but might even have a duty to do so, if those basic recommendations are not followed.

Payroll Tax Notes

Conducted by SAMUEL S. RESS

Unemployment Insurance—State Advisory Council Report

The annual report of the State Advisory Council on Employment and Unemployment Insurance for the year 1953 has been submitted to the Governor and to the State Legislature. The Advisory Council consists of employer, labor, and public representatives with one of the latter designated as chairman by the Governor, who appoints all of the members of the council.

Suggested Legislative Recommendations of the Advisory Council

It recommends extending unemployment insurance coverage to employers of one, two, or three persons not presently covered by the law. The Council points out that enactment of this provision would bring into coverage about 300,000 employers who pay social security taxes to the Federal government but are exempt from the state unemployment insurance tax.

Other proposed amendments by the Council deal with increasing the benefit maximum from $30 to $35 per week, modifying the benefit formula, the Division's housing problem, legal representation for claimants in court, and simplifying the definition of a valid original claim.

If the last proposal should be adopted by the Legislature and approved by the Governor, it could reduce the reporting burden on employers and ease some administrative problems.

The General Account—Will an Emergency Additional One-Half Percent Tax Be Required for 1955?

There is a "sleeper" in the present unemployment insurance law that may require all employers in the state to pay an additional emergency contribution of one-half percent of their taxable payrolls over and above their experience rate assigned for the year 1955. If the December 31st balance in the General Account is less than one and a half per cent of the total annual payroll of all covered employers, then all covered employers in the state would have to pay an emergency contribution of one-half of one per cent for the following year.

It appears that while the Unemployment Insurance Trust Fund, from which unemployment benefits are paid, has grown from $976 million to $1,312 million, the General Account has dropped from $282 million to $227 million. The General Account is increased by the interest earned on the unemployment trust fund, about $29 million a year, contributions paid on wages which are not remuneration, contributions paid by employers for periods prior to the second quarter of 1951, refunds of benefit payments, contributions paid by employers for reimbursements in delinquency cases, transfers from hearing deposit fund, and lapsed balances.

The General Account is reduced by negative balances of employer's accounts, benefit payments not chargeable to any employer's account, issuance of initial account balances

SAMUEL S. RESS has been an Associate Member of our Society since 1936, and is also a member of the Bar. He has specialized in the payroll tax field since the inception of this type of legislation in 1936.

Dr. Ress is Vice Chairman of the Society's Committee on Labor and Management and a member of its Committee on State Taxation.

previously withheld from employers, and corrections in initial account balances.

In order to forestall the imposition of the emergency contribution within the next year or so, remedial legislation is called for.

Request Reporting System

The Advisory Council attributes the success of the request reporting system to two provisions in the law relating to the $10 penalty for each employer-failure to respond within 7 days, and settling a claim on the basis of the claimant's own record of work and earnings in the absence of a timely employer report. It is pointed out that for 1953, employer replies have been 95 per cent timely. The writer respectfully submits that the penalties which have caused much hardship in numerous cases should be eliminated or applied less stringently.

Since benefits have been paid successfully on the basis of claimant's own records without having to make use of the employer's L. O. 12 report, perhaps it would be advisable to follow that practice in all cases as suggested by the Advisory Council. The L. O. 12 report would be used for verification purposes only, and the short period of time within which the report is required at the present time could be extended to 2 or 3 weeks without difficulty.

March 24th, 1954, State Tax Committee Meeting

All members of the Society who have had L. O. 12 Ten Dollar penalty problems should attend the March 24th, 1954, technical meeting of the Society's Committee on State Taxation. The Committee has invited Paul Mayer, the Director of the New York State Unemployment Insurance Accounts Bureau, to discuss with the members of the Society what can be done to eliminate these penalties. He will have with him on the platform a panel of his principal aides, Messrs. Bass, Cooper, Green, and Mattersdorf, to help resolve the complaints voiced by many members during the past year about these penalties and other unemployment insurance matters.

Samuel S. Ress, Chairman of the Subcommittee on Unemployment Insurance, will talk on "When and How CPA's Can Help Clients Lower Unemployment Insurance Taxes." There are many ways in which the CPA can help his client reduce these heavy payroll overhead costs. With a more difficult economic situation facing business generally, this tax-saving pointer opportunity should not be passed up.

Jack Schlosser and Miriam Eolis will talk on "State Tax Legislation Recently Enacted" and "Estate Tax Problems." All the members of the Society's Committee on State Taxation will be present for the question and answer period .

Members should submit their questions in writing in advance of the meeting for authoritative answers. Send all questions to the Committee on State Taxation, c/o New York State Society of Certified Public Accountants, 677 Fifth Avenue, New York 22, N. Y.

OFFICIAL DECISIONS *and* RELEASES

THE NEW YORK STATE SOCIETY OF
CERTIFIED PUBLIC ACCOUNTANTS
677 FIFTH AVENUE
New York 22, N. Y.

November 23, 1953.

New York State Board of Certified
Public Accountant Examiners,
23 South Pearl Street,
Albany 7, N. Y.

Gentlemen:

At a recent meeting of the New York State Society Committee on Cooperation with the State Education Department (whose members also included a member and a former member of your Board), the matter of the newly revised form entitled "Affidavit of Employer" was discussed in some detail. Consideration of this matter was undertaken because of urgent requests therefor made by several members of the Society.

The discussion centered around two questions on the form which involved the subject of "write-ups": the form requires the employer to state whether the experience indicated thereon includes write-ups and, if so, to what extent.

Several points were raised in this connection:

(1) No rule has heretofore been promulgated by the Board indicating whether the Board intends to accept any experience which includes write-ups; or whether the write-up experience will be scaled down in some manner and to what extent. The smaller practitioners are particularly concerned with this point because it affects their ability to attract staff members since, obviously, no candidate for the CPA certificate will accept employment if the experience gained thereunder is not acceptable to the State Board of CPA Examiners.

(2) The point was also made that what the Board was evidently aiming to exclude was an excessive amount of routine bookkeeping work. It was stated that certain types of write-up work were quite valuable in the experiential background of

candidates, since they involved important accounting processes; and that, to a certain extent, any kind of write-up experience, added to the background of a candidate.

(3) It was also pointed out that in certain portions of the State, write-ups constitute a normal portion of the practice in those communities; that such work involved more than mere bookkeeping routine, and constituted a valuable professional service to the public, as well as a basis for the preparation of tax returns.

It was the sense of the meeting that it would be most helpful if the Board would make clear its purpose, and state how it proposed to achieve it by the use of these questions in the area of write-ups. Also, that it would be desirable to permit, or even require, the employer to describe the nature of any write-up experience in sufficient detail so that it might be evaluated properly in the light of the stated purpose and included in the experience total where proper so to do.

In this connection, the Board's attention is respectfully directed to the editorial over the signature of Mr. John L. Carey, Executive Director of the American Institute of Accountants, which appeared in the November, 1953, issue of *The CPA* (membership bulletin of the A.I.A.). Speaking for the national body, Mr. Carey makes quite clear that write-up work may, in certain circumstances, be a truly professional service which would merit consideration and acceptance as such.

We would request, therefore, that the questions raised in this letter receive the early consideration of your Board in the hope that you will then see fit in your reply to state your views and your position with respect to write-up experience. This should serve to allay the apprehension and remove the confusion and uncertainty which now exists in the minds of many employer CPAs as well as candidates for the certificate. We shall be happy to give your reply wide circulation among our State Society members and thus assist the Board in advancing professional standards in the performance of its official functions.

Very truly yours,

/s/ SAUL LEVY
Saul Levy, Chairman
Committee on Cooperation with
State Education Department

THE UNIVERSITY OF THE STATE OF NEW YORK

THE STATE EDUCATION DEPARTMENT

STATE BOARD OF CERTIFIED PUBLIC ACCOUNTANT EXAMINERS

MR. SAUL LEVY, *Chairman,*
Committee on Cooperation with
State Education Department,
The New York State Society of
Certified Public Accountants,
677 Fifth Avenue,
New York 22, N. Y.

February 16, 1954

Dear Mr. Levy:

We thank you for your letter of November 23, 1953, advising us of your Committee's discussions relative to the Affidavit of Employer, and of the concern, principally among small practitioners, as to what consideration has been given to write-ups in determining whether a candidate has had sufficient experience to enable him to take the Practical Accounting and Auditing Examinations.

The Board of Examiners has always endeavored to make a fair evaluation of the experience offered by candidates to ascertain whether such experience meets the requirements of the regulations, which specifies "three years' experience in the intensive diversified application of accounting principles and in the intensive diversified application of auditing procedures in the public practice of accountancy". The Board has not excluded write-up work *per se,* but has tried to appraise such work in relation to the candidate's overall accounting experience. Where write-up work was not limited merely to routine bookkeeping, but was integrated with other public accounting services, the Board has recognized that acceptable experience had been gained and that credit should be given.

In view of the difficulties referred to in your letter, the Board has decided to eliminate Question 10 from the Affidavit, and to substitute therefor a request that the employer indicate the nature of the accounting and auditing work, including write-ups, performed by the applicant. Such description coupled with the employer's answer to Question 11, which requests the employer's opinion as to whether the candidate's employment constituted full-time diversified public accounting experience, should enable the Board to evaluate such experience and decide whether or not it comes within the requirements of the regulations.

Very truly yours,

/s/ JOSEPH I. LUBIN
Joseph I. Lubin, Chairman,
State Board of
Certified Public Accountant Examiners